PROBLEM OF FISCAL STABILIZATION IN INDIAN ECONOMY SINCE SEVENTH PLAN

ABSTRACT

THESIS

SUBMITTED FOR THE AWARD OF THE DEGREE OF

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IN

ECONOMICS

BY

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Under the Supervision of

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ABSTRACT

Fiscal policy is among the most potent instruments of economic policy. Through it the government creates and sustains the public economy consisting of the provision of public services and public investment, at the same time, it is an instrument for re-allocation of resources according to national priorities, redistribution, promotion of private savings and investments, and the maintenance of stability. Thus the fiscal policy must be geared to the sustenance and growth of the public enomomy and to help achieve the broader objectives of planning. This implies that the methods of raising resources for the public sector should be such as to influence the rest of the economy in beneficial ways and within the public economy itself resources must be used in the most efficient way.

Role of the government which was confined only to providing essential public service in the pre-war period has been extended to the sphere of social welfare and public sector investment for maintaining economic stability as well as promoting economic development in developing countries in the post-war period. Public debt which was intended to be used in emergencies has come to be justified for the purpose of economic stability and development, and subsequently it has been extended to the financing of the deficit. These expansions in the government operations have caused the size of the government budget to increase very fast. Therefore, high fiscal deficit become common phenomenon in many developing countries in the recent past.

There is general agreement among economists that runaway public expenditures as compared to nearly stagnant revenue receipts

played crucial role in the inception of fiscal imbalance in many developing countries as well as in India. Excessive borrowings and loss-making public sector enterprises added fuel to the fire. On account of these factors all the indicators of the deficit were on the rise by the end of eighties especially in India. S. K. Singh, M. Rakshit, S. Mundle et al., S. Gulati, U. Kapila, Datta and Sen, Ghosh and Sen, P. B. Nayak, M. G. Rao and others have shown in their studies that outpacing of revenues by public expenditure since early eighties lead the government to substantial borrowings, which further widened the gap between revenue and expenditure. According to them these consequential extensions and expansions have caused the problem of fiscal stabilization.

The study covers a period of fifteen years, from 1985-86 to 1999-2000. The choice of the period in reference is basically because a number of events took place in the fiscal area of the Indian economy during this period. In 1985-86 the government of India announced its Long Term Fiscal Policy (LTFP). It concerns with that part of fiscal management which relates mainly to direct and indirect taxation by the centre. In 1991-92 government of India announced its Fiscal Adjustment/Stabilization Programme in order to combat the deepening fiscal crisis. After that a number of important steps have been taken by the government to restore fiscal stabilization. These events generated interest to study the whole problem with a new approach.

To accomplish our endeavour required data have been taken from reports and periodicals published mainly by, Ministry of Finance, Reserve Bank of India, Central Statistical Organisation, and other departments/

offices of the Government of India. Besides these sources we have also taken data published by CMIE and the World Bank. In our study we have used both statistical as well as theoretical approach.

In our study, we have analysed the experience of the developing countries regarding fiscal instability and fiscal corrective measures. In our study we found that the factors responsible for the fiscal crisis in most of the developing countries were common in nature. Due to declining share of direct tax in the total tax revenue and the declining buoyancy of custom duties because of higher rates, the tax revenue remained stagnant as a proportion of GDP in the countries experiencing fiscal crisis. Stagnant revenues coupled with rapid growing public expenditure and public debt indicted as main culprits behind the creation of fiscal imbalance. In order to put their fiscal house in order, countries adopted fiscal adjustment/stabilization measures. Their experience reveals that fiscal stabilization cannot be achieved through shock therapy, good fiscal measures always took time.

Our analysis of the problem during seventh plan period shows that expenditures had been outpacing revenues for more than a decade, leading the government to substantial borrowings. Consequently interest payments become the single largest component of the expenditure of the central government. Our analysis have identified the problem related with the tax system. The problem was that the share of direct tax (which is considered most buoyant) had virtually stagnated during the entire eighties, it started out at 2.20 per cent of GDP in 1980-81 and stood at around 2.19 per cent of GDP in 1988-98. Thus whatever increase had been in the tax revenue brought about by exploiting indirect taxes. On considering dis-aggregated figures for direct and indirect taxes during the seventh plan period, we find that performance of direct taxes has been far behind the targets. Indirect taxes, however, performed better, exceeding seventh plan projections by a significant margin. It was certainly a very unhealthy development. However, overall tax revenue performance during the seventh plan as compared to sixth plan seems to be satisfactory. Gross tax revenue of the central government as a proportion to GDP moved from 9.93 per cent during sixth plan period to 11.20 per cent during the seventh plan period.

During the seventh plan period government expenditures far exceeded the revenue receipts. During the period in reference public expenditure of the central government was 20.48 per cent of GDP. This was particularly due to sharp rise in expenditure on interest payments, defence, and food and fertilizer subsidies. Interest payments contributed most to this unabated growth of expenditure. From 9.6 per cent of the total expenditure in 1981-82 interest payments rose to 16.4 pe rcent in 1990-91. Thus our analysis of the problem during seventh plan period have shown sharp rise in expenditures on subsides, transfer payments, wages and salaries, food and fertilizer subsidies and sharp decline in the share of capital expenditure. This acceleration in the government expenditure has led to the emergence of severe fiscal imbalance.

We have also analysed the contribution of the public sector enterprises in the emergence of fiscal instability in Indian economy. Net profits of these enterprises have declined from Rs.3789 crore in 1989-90 to Rs. 2368 crore in 1990-91. The rate of return, as measured by the ratio of net profits to capital employed, declined from 4.5 per cent in 1989-90 to 2.3 per cent in 1990-91, the lowest since 1984-85. It is clear from our analysis that poor returns form investments made in the public sector enterprises had been one of the main contributory factors in the inception of fiscal crisis.

Since this fiscal deficit had to financed by treasury bills and market borrowings, as a result the internal debt of the government increased rapidly from 42 per cent of GDP at the end of 1980-81 it rose to 53 per cent of GDP at the end of 1990-91. The danger of the government falling into debt-trap was inevitable. During the seventh plan period government also relied partly on issuing of the treasury bills for the financing of the deficits. This in turn had resulted in huge monetized deficit. Consequently, money supply grew at an average annual rate of about 17.5 per cent during the period in reference. This contributed to the double digit increase in inflation by the end of 1990.

Thus it is clear from the analysis of the problem during seventh plan period, that throughout the eighties, all the important indicators of fiscal imbalance were on the rise. The state of our public finances had reached crisis proportions by the end of eighties. Evidently, a stabilization programme, reversing the growth in the budget deficit, revenue deficit, fiscal deficit, and tightening monetary policy was called for.

We have analysed the fiscal reform measures introduced in 1991-92. The immediate aim of fiscal reform was to improve the fiscal balance in order to eliminate the inflationary pressure emanating from the budget deficit. The other objectives of the fiscal reform were to stop further accumulation of public debt, to reduce the level of subsidies in the economy, to direct government expenditure towards providing essential public services of a high quality, and to restore the government's capacity to make strategic investments in infrastructure and human resources.

The government has recognised the link between compression of expenditures, tax reform and programme of fiscal stabilization. Fiscal stabilization requires a reduction in the fiscal deficit. While some of this can be achieved by reducing low priority expenditure, some of the improvement has to come from high tax collections. For this purpose government has introduced cuts in expenditure specially in regard to the emoluments and size of the bureaucracy, and subsidies to food and fertilizers. Also, government appointed a committee on tax reforms under the chairmanship of R.J. Chelliah. Government accepted the recommendations of the committee, emphasising tax reforms aimed at simplifying the structure and continuing the process of shifting to moderate rates of taxation.

Inefficiencies and poor financial performance in public sector enterprises have contributed to the fiscal crisis. The reforms aim to increase efficiency and reduce losses that so many public enterprises impose on the government budget. In addition to this, two other key elements of the government's strategy for public sector enterprise reform are the promotion of increased private sector competition and partial disinvestment of equity in selected enterprises. For the retirement of public debt the objective of the fiscal policy reforms was to use the proceeds from privatisation/disinvestment, so that the interest burden is progressively reduced. Fiscal reforms have also recommended a sound management of monetary policy in the interest of financial stability, as many of the problems in the financial sector stemmed from the fiscal deficits.

Our analysis of the effects of fiscal correction measures on fiscal stabilization shows that government succeeded partially in the restoration of fiscal stabilization. Though the growth of expenditure has been controlled marginally, the tax revenue as a ratio to GDP declined during the reform period. Our analysis of the revenue implications of tax reforms shows that compared to indirect taxes, direct taxes were more buoyant during the nineties. Between 1990-91 and 1999-2000, when there were substantial tax rates reductions, the ratio of gross tax revenue to GDP declined from 10.8 per cent to 9.2 per cent. Among the different categories of taxes, customs and excise duties as a proportion of GDP declined sharply from 3.9 per cent to 2.6 per cent and from 4.6 per cent to 3.3 per cent respectively during the period in reference. However, there was an improvement in terms of direct tax to GDP ratio. Between 1990-91 and 1999-2000 yield of personal income tax and corporation tax as a percentage of GDP increased from 1.0 per cent to 1.4 per cent and from 1.0 per cent to 1.6 per cent respectively. This is the reason why even though the direct tax/GDP ratio increased during this period, growth in total tax revenue could not keep pace with the rate of growth of GDP. The analysis of the movement of tax rates and income elasticities of various taxes shows that generally reduction in tax rate cannot make a tax more buoyant instantly. There is a time lag involved. Average income elasticity of total tax revenue declined from 0.91 during the period of 1991-92 to 1995-96 to 0.73 during 1996-97 to 1998-99. If the tax level in the pre-reform years is to be achieved, tax revenues have to grow with a rapid pace as compared to GDP. To be realistic, if the centre's revenue is to grow faster the pick up has to come from union excise and custom duties.

It becomes clear from examination of the data that total expenditure of the central government declined from an average of 19.66 percent of GDP in 1990-91 to 15.73 per cent in 1999-2000. While capital expenditures as a proportion of GDP have fallen sharply from 5.9 percent during 1980-81 to 1991-92 to 2.7 per cent during 1992-93 to 1999-2000 and revenue expenditures have marginally increased form 11.7 per cent to 12.2 per cent during the period in reference. Our analysis also shows that during the nineties plan expenditures have declined sharply as compared to non-plan expenditures. Interest payments now constitute the single largest component of expenditure of the central government. Our analysis suggests that rising expenditure on interest payments has dampened the pace of expenditure compression.

A few distinct trends have been drawn from the analysis of the effects of the reforms in public sector undertakings. In 1991-92 profit after tax to net worth in 237 central PSUs, was only 3.9 per cent, which rose to 8.9 per cent in 1998-99. Disinvestment in PSUs have fallen short of expectations during the reform period. It is also clear that reforms in the PSUs have not helped much in the reduction of fiscal deficit.

As far as financing of the government's deficit is concerned, till the early nineties a considerable part of the deficit was financed with borrowing from the central bank. The interest rates on such borrowing were much lower than the interest rate on borrowing from the open market. Later, a gradual shift away from borrowing from the central bank to open market borrowing, resulting in a sharp rise in the explicit interest cost of the fiscal deficit. During the period between 1980-81 to 1991-92 share of market borrowing in financing of the gross fiscal deficit was 26.2 per cent, which rose to 49.7 per cent during the period of 1992-93 to 1999-2000. The study makes it clear that even putting an end to the practice of monetising the deficit has hardly affected the fiscal situation. Fiscal deficits remain high, though they are now financed by high interest open market borrowings. The only result is that the interest burden of the government tends to shoot up. Interest payments as a percentage of GDP have risen from 3.4 per cent during 1985-90 to 4.6 per cent during 1995-99. As a result revenue deficit of the central government has increased from 3.3 per cent of GDP in 1990-91 to 3.9 per cent of GDP in 1998-99.

To sum up, we can say that fiscal correction measures have not delivered the fiscal results as expected. In the recent past the budgets of the central government were out of balance. There was not only a wide gap between revenue and expenditure but the composition of expenditure was also quite out of line. Revenue structure needs to be altered to make it more broad based and equitable. The key objective of future's fiscal reform has to be a reduction in debt service payments. This has to be achieved by a progressive reduction in public debt and through higher revenues. Higher tax revenues can be achieved only through buoyancy and expansion of the tax base . The share of interest payment in total expenditure may be brought down by retiring some of the debt. Through the sale of seized gold and some of government lands and through disinvestment in public sector undertakings, a sizeable amount could be raised and used for the retirement of the debt. Ensuring long-term fiscal health of the economy requires higher buoyancy in tax revenues and compression of non-essential expenditures. Apart from this the key solutions to India's fiscal predicaments are bold programmes for imposing user charges on all public services amenable to such charges, and the implementation of crash programme of privatisation. The fiscal health of the economy may improve swiftly, if this correction is made.

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CERTIFICATE

This is to certify that Mr. Mohd. Azam Khan has completed Ph.D. thesis on **"Problem of Fiscal Stabilization in Indian Economy since Seventh Plan"** under my supervision. His research work is original and worth submitting for the award of the degree of Ph.D. in Economics of this University.

(Dr. Masood Hasan)
Supervisor

PREFACE

During late seventies and early eighties many developing countries experienced the problem of fiscal imbalance. Alongwith high fiscal deficit, deficit on balance of payments accounts, high inflation and indebtedness have turned the problem into a severe crisis. In India, problem of fiscal stabilization incepted in the early eighties and reached to a crisis proportion by the end of the decade. There is wide agreement among economists that stagnant revenue receipts as a ratio to GDP coupled with rapidly growing public expenditure and excessive borrowings were important factors responsible for the problem of fiscal imbalance. Government of India under the guidance of IMF and World Bank introduced fiscal adjustment/stabilization measures in 1991-92, which states that government should discourage wasteful public expenditure and conspicuous consumption and reform tax structure to increase the buoyancy of the taxes. These measures have been considered necessary to ensure viable and sustainable fiscal stability.

With this background, this study attempts to evaluate the factors responsible for the fiscal imbalance in India. Fiscal correction measures and its impact have also been reviewed and analysed. The analytical approach in this thesis affirms that growing mismatch between revenue receipts and expenditure alongwith non-performance of public sector undertakings, collectively aggravated the fiscal crisis. Analysis of the effect of fiscal stabilization measures reveals that government succeeded partially in the restoration of fiscal stabilization. Though, the growth of expenditure has been compressed marginally, the tax revenue as a ratio to GDP declined after the introduction of reforms. By the end of nineties, due to government's reluctance for deficit financing, inflation has been brought down at its lowest level whereas the revenue deficit increased sharply as a result of interest payments becoming single largest component of expenditure, which was due to greater reliance on market borrowings for the financing of the fiscal deficit.

Finally, it may be concluded that, the fiscal corrective measures already initiated by the government, needs more time in order to ensure sustainable fiscal stability.

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INTRODUCTION

1.1 CONCEPT OF FISCAL POLICY

There are two major types of policies which the government can adopt to influence the level of economic activity : fiscal policy and monetary policy. Fiscal policy refers to changes in government spending and taxation including debt-management. Monetary policy is mainly conducted through measures designed to influence the money supply or the level of interest rates. There is considerable overlap between the two policies. A change in fiscal policy affects the monetary side of the economy and this in turn affects the results of the original change in fiscal policy.

Before we proceed our discussion further, it would be rewarding to have a brief background of the evolution of the idea and philosophy of fiscal policy.

Though the concept of fiscal policy emerged only after the Keynesian revolution in economics, its basic philosophy can be traced to the eighteenth century. However, the scope of government economic activity widened substantially only during and after the Great Depression of 1930s. During this period, the role of the government in maintaining economic stability came to be theoretically as well as politically justified and this role was found to be in harmony with achieving growth of national output and reduction of economic inequalities. During the post war years, the scope of the role of government further widened particularly in the developing countries in the context of the need for government economic planning for achieving rapid economic development. As a result of all these additional responsibilities, the governments in the developing countries have been called upon to defend their borders, maintain law and order, provide necessary social and economic infrastructure facilities, maintain economic stability, promote economic development, effect redistribution of income and wealth, function as entrepreneurs and promote consequential social objectives.

'The fiscal operations of the government for promoting the economic development of the less developed countries are as an investor, as a stabiliser, as a saver and as an income redistributor'.[1]

Thus, it may be observed that fiscal policy which emerged as a branch of applied economics under the name of macro-economic analysis has grown in its coverage. And today it is very difficult to say that fiscal policy covers only macro-economic policy at least with reference to a developing economy like India. Fiscal policy in developing countries involves a judicious mixture of macro-economic policies of the government to achieve multiple objectives.

The government in modern democracies discharges the above mentioned various and varied socio-economic responsibilities mostly through the instrumentality of its budget. The budget includes an annual estimate of expenditure to be incurred, expected revenue, borrowing and debt repayment with a view to achieving explicit objectives of the government. In order to be effective in achieving these objectives, the budgetary instruments namely, taxation, borrowing, lending, spending and transfer payments should influence the national economy through the major economic variables such as levels and rate of growth of income, consumption, prices, balance of payments etc. both at aggregate and sectoral and micro levels. When these economic variables are influenced by the national budget, they in turn influence various components of the budget through the change in their levels, rates of growth and direction. The influence of the budget on the national economy is mainly deliberate as various budget instruments are altered so as to alter significant variables. However, a well designed fiscal policy may also influence the economy automatically during the interval between two budget periods or policy decisions. This is known as the 'built-in-flexibility' of fiscal measures. Similarly, the economy after being influenced by the budgetary policies experiences significant changes in terms of major economic variables of the economy such as income, consumption, price, etc., but also gets the automatic responses through the level of expenditure, etc. In this way the national fiscal policy and the national economy interact mutually. But the main objective of fiscal policy is to influence national economy in the desired direction rather than being influenced by it.

Fiscal policies are required if society desires to alter the distribution of output between government and private uses. This is a special case of the general choice between consumption, private investment and government expenditure. The problem of dividing output correctly for final use is a matter of efficient allocation of resources and the solution depends on the preferences of society. Fiscal policies are also required to promote equity in the distribution of income and wealth.

Volatile disturbances distribute the income and capital losses from inflation or unemployment in a haphazard manner which is contrary to society's expenditures are the only feasible methods available for mitigating the haphazard incidence of misfortune. Efficiency and equity considerations require that fiscal policies form an important role in the formulation of economic policies.

1.2 PROBLEM OF FISCAL STABILIZATION

As we have explained earlier, the role of the government has to be extended to a vast variety of fields and today the objectives of fiscal policy have multiplied. For example, during the days of Laissez-faire philosophy when the government was confined to the limited area, the main objective of taxation was to raise revenue adequate enough to meet the minimum requirements the 'police state' functions. But subsequently when the role of government got extended to economic development, the role of taxation has to be identified with raising resources or diversion of increased income from the private sector to the public sector for increasing total savings. Similarly, the role of public expenditure which was confined only to providing essential public service has been extended to the sphere of social security, old age pension and the like plus public sector investment for maintaining eocnomic stability as well as promoting economic development in developing countries. Public debt policy which was intended to be used in emergencies like war has come to be justified for the purpose of maintaining economic stability and subsequently it has been extended to the area of economic development. These consequential extensions and expansions in the field of taxation, public expenditure and public borrowing have caused the size of the government budget in the democracy to increase very fast. Adolf Wagner hypothesized that as economic development proceeds in a smooth linear line, the demand for 'public goods' will increase and as a result the government expenditure will increase faster than the national output. But the government expenditure has increased even during the period of economic stagnation. Now, we can say that these trends led the economy towards fiscal imbalance.

During the past two decades stagnant revenues along with difficulties in compressing public expenditures, resulted in high deficit in many developing countries. With foreign borrowings fore-closed, government were left with no choice except domestic soruce of financing or market borrowings. The ensuing increase in money supply could only result in runaway inflation. Excessive reliance on borrowings have pushed a number of economies into debt-trap. Problem of fiscal stabilization further worsened due to all these factors, and a vicious circle of fiscal imbalance has emerged.

1.3 NATURE OF THE PROBLEM IN INDIAN ECONOMY

It is now widely agreed that the Indian economy was undergoing a severe crisis by the end of the 1980s. The crisis was possibly the severest that the country has had to face in the post-independence era. The fiscal sector of the economy was possibly in the throes of its most stringent test ever. The foreign trade sector of the economy was in great trouble. In the fiscal sector government expenditures were outpacing revenues in the current account for more than a decade leading the government to resort to substantial borrowings. The public debt had reached to such a level that interest payments constitute the largest single expenditure head of the central government. Non-essential expenditure continues to grow unabated, the explanation for which can not be confined to strictly economic factors.

All of the trends noted above have been the wages of a soft state where government expenditures have bloated way out of proportion to tax and non-tax revenues. Faced with a resource crunch, when budgetary allocations have had to be trimmed, it has invariably been capital that has had to be axed, while revenue expenditure has gone on expanding. Powerful vested interests have emerged to keep the fiscal economy running in this manner.

The implications of the above trends on the monetary sector were immediate. Alongwith the large revenue deficits the central government has had large budget deficits averaging about 2.5 per cent of GDP during the seventh plan period. This in turn has contributed to a large monetised deficit. It is this which determines the growth of money supply. Money supply grew at an average annual rate of over 17 per cent during the seventh plan period, causing a substantial liquidity overhang in the economy. This contributed in a large measure to the double digit increase in the inflation that the economy went through during 1990-91.

The fiscal situation, which had been under mounting pressure throughout 1980s, assumed crisis proportions by the begining of the

1991-92. The gulf war exacerbated the already precarious fiscal situation. At a macro-economic level, fiscal deficits, besides contributing to inflationary pressures, have also been seriously spilling into balance of payments.

Throughout the eighties, all the important indicators of fiscal imbalance were on the rise. These are the budgetary deficit, the revenue deficit, the monetised deficit and gross fiscal deficit. Such a fiscal situation has become unsustainable. Evidently, a stabilization programme reversing the growth in the budget deficit and tightening monetary policy was called for.

1.4 PROBLEMS IN THE MEASUREMENT OF FISCAL IMBALANCE

The correct measurement of the fiscal imbalance is fraught with formidable difficulties.[i] These difficulties have been often ignored by economists. The commonly used measures of the fiscal deficit can be highly inadequate. They may not be comparable over time. And they are often imprecise gauges for determining the size of the needed fiscal correction. The difficulties are several.

The first difficulty is connected with the quality of the data. With few exceptions, governments have not given a high priority to the gathering and provision of reliable and up-to-date statistics. In fact, governments have shown little interest in improving the quality of the fiscal data.

The second issue concerns the comprehensiveness of the available fiscal data. The central government, which is often the main actor and the centre of attention in stabilization programmes, represents in many countries, only a limited part of the public sector. The whole public sector is compartmentalized into the central government, state governments and municipilities, public enterprises, the central bank, stabilization funds, various forms of extra budgetary accounts including social security, and so forth. These compartments are often interconnected and some sort of implicit transfer prices are used to determine the scope of financial or resource flows among them. These transfer prices often do not reflect market prices. The public enterprises may sell services to the central government at below market prices or they can borrow to reduce transfers form the central government. All these examples mean that in many cases the fiscal deficit can be 'parked' in compartments of the public sector where it can be least embarrassing politically or where it can be financed most easily in the short run.[ii]

To avoid this problem, the data on which the fiscal stabilization should be based must be comprehensive enough to encompass the whole or much of the public sector. But this is extremely difficult or may even prove impossible because the information required is often not available, or if it is available, it is not up-to-date. This limitation may create serious difficulties in the conduct of fiscal policy. For example, a programme that emphasized a reduction in the fiscal deficit of the central government might encourage maneuvers to push the deficit out of the central government into the state governments etc.

Some of these problems often arise out of the fact that the fiscal deficit, as conventionally measured (i.e. total expenditure less ordinary revenues), is highly sensitive to the rate of inflation and to the exchange rate.

In the presence of domestic debt, inflation can bring about dramatic changes in the size of the fiscal deficit by increasing nominal interest rates and thus nominal interest payments. In such situations it ceases to provide useful measure of the size of the fiscal correction needed by the stabilization programme. Other definitions of the fiscal deficit have been introduced in recent years and are often used in stabilization programmes. One such concept is the operational deficit which seeks to remove from total expenditure the part of interest payments, that is considered a 'monetary correction'. The practical measurement of the operational deficit is very difficult and its theoretical underpinnings are controversial.[iii] Therefore, this concept, though useful, must be treated with caution.

The primary deficit which excludes all interest payments from the measurement of the deficit, is a tool more useful in assessing the size of an adjustment. The primary deficit or rather the primary surplus is useful in providing an indication of the amount of current resources available to a government to service its public debt. It has limited value in indicating what the fiscal correction should be.

Timing issues also create difficulties. A deficit can be measured on the basis of cash flows (i.e. actual cash receipts and payments) or it can be measured on a commitment basis for expenditure and on an actual basis for revenues. When arrears are increasing, an adjustment programme which employs the cash concept may miss the pressures on resources and on demand associated with expenditures made but not yet paid for.

1.5 FISCAL AND BUDGETARY DEFICITS : SOME DEFINITION AND ISSUES

In recent years the official documents have listed the following concepts of deficits in the government accounts.

(1) RD (Revenue Deficit) = Revenue Expenditure - Revenue Receipts.

(2) BD (Budget Deficit) = Total expenditure - Total Receipts (excluding net sale of treasury bills).

(3) DF (Deficit Financing) = Increase in net RBI credit to the government.

(4) FD (Fiscal Deficit) = Total expenditure - (Revenue receipts + Recovery of loans + Receipts from the sale of assets).

(5) DCA (Deficit on Capital Account) = Capital Expenditure - Capital Receipts (excluding net sale of treasury bills).

(6) PD (Primary Deficit) = Fiscal Deficit - Interest Payments

RD is the deficit generated through current transactions in the budget and denotes the dissaving of government administration and defence. BD as noted in (2), indicates the amount of government expenditure financed through net sale of treasury bills during the financial year (irrespective of who buys these bills). DF gives the net increase in the RBI holding of treasury bills plus other government securities less increase in government deposits with the Reserve Bank. FD constitutes the increase in gross indebtedness of government administration and defence to the rest of the economy (or the world). It follows from the earlier relations that DCA is the sum of net sale of treasury bills less the revenue deficit of the government. PD stands for gross borrowings of the government required to meet all expenditure less interest payments.

The relevance or the usefulness of these various concepts of deficits depends on the purpose at hand and on the extent they can be manipulated by the government for attaining its eocnomic objectives. From the viewpoint of economic analysis and policy prescription, our focus has to be on the significance of these deficits for the generation of aggregate demand or inflationary pressures; for the over all saving ratio or economic growth, for the transfer of resources between the private and the public sectors, and for the sustainability of public debt or the solvency of the government.

1.6 REVIEW OF LITERATURE

Before embarking upon a research project it is absolutely essential to review the literature on the same or similar subject. Keeping this in mind an effort has been made here to review some of the existing literature on fiscal stabilization.

Chelliah, R.J. (1969)[2] in his study of fiscal policy in less developed countries attempts to analyse the fundamental problems of fiscal policy in less developed countries, the basic structure of public finance with emphasis on tax structure and fiscal policies, against the background of planned eocnomic development. The greater part of his work is carried on with special reference to India. He has also observed that the fiscal policy appropriate for a country will depend, apart from many other factors, on the stage of its development and on the social grounds.

Musgrave, R.A. (1969)[3] in his study of fiscal systems has examined the essential characteristics of fiscal systems in the context of certain key features of economic life. His study deals with the adaptation of fiscal systems to the requirements of centrally planned and decentralized or market economies. He also examined the interaction between fiscal systems and economic development and compared the tax structure of a number of highly developed countries. In his study he also raised the issues like fiscal centralization versus decentralization, the formulation of the budget plan, the impact of governmental forms on fiscal behaviour, social security and transfer systems, and the structure and management of public debt.

Gowda, K.V. (1987)[4] in his work has criticized the long term fiscal policy (LTFP) that it has placed exclusive reliance not on fiscal policy with all its various segments. For it does not touch on expenditure policy, monetary policy, debt management and international economic policy but on tax policy. In his study he explains how fiscal policy instruments are to be integrated with all other instruments of macro-economic policy in order to realise the desired results and underlines the complications of pursuing fiscal policy in isolation.

Singh, S.K. (1988)[5] has examined the nature of the fiscal crisis in India and evaluated long term fiscal policy as a response to this crisis. The study explains that since 1975-76, the tax ratio has not kept pace with the expenditure ratio resulting in the long-term imbalance between government revenues and expenditures. This gap which widened during the sixth plan became much larger during the seventh plan. Thus the central government has to borrow even to meet its current expenditure. His analysis indicates that the LTFP, as a response to the challenging problem of fiscal crisis, has failed to offer any clear direction in two vital areas, namely, (i) how to restrain the increase in non-plan expenditure on revenue account, and (ii) how to augment the surpluses of PSUs. Finally, he has warned that without proper advance in these areas the fiscal crisis will persist.

Rakshit, M. (1991)[6] in his work has studied the fiscal roots of macro-economic imbalance in India, and found that during 1980s, fiscal imbalance assumed alarming proportions due to widening gap between revenue and expenditure. In his work he has discussed macro-economic adjustment programme introduced by the government to resolve the fiscal crisis. Finally, he raises a number of important issues regarding viability of fiscal management.

Mundle, S. and M. Govinda Rao (1992)[7] have analysed the nature of fiscal crisis in India in 1990 and related issues in the growth and composition of public expenditure, the tax system and mobilisation of tax revenues and non-tax revenues. They have shown that the fiscal imbalance was mainly a reflection of the increasing gap between revenue receipts and revenue expenditure. There was a spurt in spending mainly on account of interest payments, subsidies, plan and non-plan grants to state governments, defence and failure of public sector undertakings etc., on the other hand, the growth of tax and non-tax revenues was stagnated. Finally, they have endorses the fiscal stabilization measures initiated in 1991.

Chhibber, A. and Mansoor Dailami (1993)[8] argues for a need for a broader approach to the relationship between fiscal policy and private investment in developing countries. Such an approach needs to emphasize the role of fiscal policy and stabilization, the competitiveness between public and private investment and the taxation of income from capital. While these issues have long been recognised in the literature in the context of both developed and developing countries, they have assumed particular urgency and importance in the context of the ongoing liberalization and privatization trends evident in most developing countries.

Cornia, G.A. and F. Stewart (1993)[9] reviews changes in the fiscal policy of developing countries undergoing economic adjustment during the 1980s. Macro-choices in the areas of overall taxation, government expenditure and fiscal deficit are first examined. It appears that although a few countries managed to combine raising government expenditure per head and a falling budget deficit thanks to increases in tax ratio and/or to overall growth, in the majority of the countries analysed, traditional fiscal policy emphasizing rapid reductions in budget deficits through expenditure reductions compounded the negative effects of falling incomes on the welfare of the poor. Finally, they conclude that the main elements of fiscal policy approach are aiming at protecting the poor during adjustment.

de Melo, Martha (1993)[10] has proposed the use of a sustainable deficit concept to estimate the minimum fiscal adjustment required in a high debt country. The sustainable deficit is defined to be compatible with a sustainable debt, which the borrower is willing and able to service. His work provides impirical estimates of the need for fiscal adjustment in a small group of high debt countries in the mid 1980s. Their experience is compared to that of a small group of low debt countries, to distinguish the differences in the adjustment requirement and its determinants during this period. The results illustrate the extent to which the appropriate size of the fiscal deficit depends on the macroeconomic context.

Faini, Riccardo and Jaime de Melo (1993)[11] takes a look at the evidence of fiscal adjustment in developing countries. They found that, while on an average, developing countries were successful after 1985 in cutting their primary deficits, rising interest costs and stagnant fiscal revenues implied limited progress towards reducing fiscal imbalances. Most of the improvement on the fiscal front was achieved by cuts in capital expenditures. Then they have focussed on issues such as the size of fiscal adjustment, the macroeconomic impact of deficit reduction and the choice between expenditure cuts and tax increases.

Gulati, I.S. (1993)[12] has dealt with some questions concerning the growing burden of internal public debt in India. These questions that have lately been raised with a stridency not noticed before focus on reducing the fiscal deficit, a term that hardly ever figured in the lexicon of fiscal policy in India.

Kapila, U. (1993)[13] in her analysis of public finances of India has shown that the fiscal situation which was under strain throughout the 1980s, reached a critical situation in 1990-91. Throughout the eighties, all the indicators of fiscal imbalance were on the rise. The unabated growth of non-plan expenditure and poor returns from investments made in the public sector have been the main contributory factor in the fiscal crisis. Government initiated the fiscal stabilization and intended to continue it. She has also suggested that for the realisation of the fiscal stabilization, it is imperative to restrain the rise of expenditures. Fiscal discipline is also necessary on the part of PSEs to hasten the process of fiscal correction.

Mookherjee, D. (1993)[14] has analysed the fiscal stabilization reforms in the Indian economy. In this work he has highlighted that at the turn of the eighties into the nineties, serious action on the fiscal front was urgently needed to correct the macro-economic imbalances. The principle instruments of fiscal stabilization in 1991-92 were plan expenditure and subsidies on exports and fertilisers. Disinvestment of equity holding in central public sector enterprises also provided a cushion. Initially government succeeded in its determined effort at fiscal stabilization and brought the fiscal deficit down.

Mundle, S. and Hiranya Mukhopadhyay (1993)[15] in their study have analysed the impact of alternative fiscal policies on macro-economic performance of the Indian economy. The most important lesson emerged from their work is that in reducing the deficit, greater revenue mobilisation would be preferable to expenditure compression. This should be attempted through tax reforms rather than raising rates. There are, however, limits to how far tax reforms can raise the buoyancy of tax revenue. Hence fiscal correction will have to depend in part on public expenditure compression. They have shown that in the post reform period public expenditure on almost all items except interest payments have been cut in real terms. However, the sharpest cuts have fallen on those items of expenditure which ought to be protected.

Tanzi, V. (1993)[16] has observed that fiscal reform, has proven difficult to implement for political, institutional and conceptual reasons. In his work he has discussed the determination of the correct size of the fiscal adjustment needed, the problems in measuring fiscal disequilibrium, the desired fiscal measures and the sequencing of the required fiscal reforms. Finally, he argues that fiscal reform require time to be successful.

Taylor, L. (1993)[17] has attempted to study fiscal policy issues that arise during macroeconomic stabilization in developing countries. His work is based on the study of stabilization episodes in eighteen countries. He has observed that the effects of fiscal stabilization and adjustment on income distribution are less clear cut and stabilization programmes should take into account specific country conditions.

Thirsk, W.R. (1993)[18] has observed that many countries have overhauled their tax systems during the past decade. His work reviews the profile of a typical developing country tax system prior to the recent wave of reforms. A detailed description of tax reforms in several developing countries is presented. Comparison across countries indicate an emerging consensus on the desirable characteristics of a tax system : neutrality and the adoption of a more uniform system of taxation, the progressive abandonment of special tax distinctions and exemptions and simpler tax designs.

Shand, Ric and K.P. Kalirajan (1994)[19] in their study indicated that the reforms implemented in India since 1991-92 have been yielding the anticipated positive results. Though the reform process has been gradual, it is becoming increasingly clear that sustainability is not in question. The study concludes that Indian economy may be evolving a new paradigm of growth which could be relevant to other developing countries with similar structural linkages.

Bhattacharya, B.B. (1995)[20] in his work has evaluated the factors responsible for fiscal imbalance in 1990 and analysed the performance of fiscal stabilization measures. He has shown that the basic problem of the fiscal stabilization in India was that the government expenditure was rising faster than the government income. As a result all the measures of deficit such as fiscal deficit, revenue deficit, primary deficit etc. have rising trends. Finally, he suggested that the fiscal deficit should be reduced by slowing down growth of non-plan and wasteful expenditures on the one hand and improving direct tax revenue and surplus of public enterprises on the other.

Datta, R. and R.K. Sen (1995)[21] have shown in their study that in India, the budgetary and fiscal deficits of the central government had been growing significantly during the sixth and seventh plan periods. They have cautioned that in the process of enforcing fiscal discipline and aiming at fiscal stabilization. Contrary steps should be avoided not only in the policy packages but also in the measures adopted at the central and state levels.

Ghosh, A. and R.K. Sen (1995)[22] have observed in their study that during 1980s not only the revenue receipts have been rather inelastic but the expenditure accounts particularly of the non-plan outlays have also gone up quite rapidly. This has been termed by them as the main cause of the fiscal imbalance. They have also suggested that it requires to be attended with policies to reduce the non-plan expenditure drastically.

Nayak, P.B. (1995)[23] in his work has revealed that in the fiscal sector, government expenditure had been far outpacing revenues for more than a decade, leading the government to resort to substantial borrowings, both internal and external. As a result interest payments become largest expenditure head of the central government budget. Non-essential expenditure continues to grow unabated. He has also observed that the tax to GDP ratio is already reasonably high and the prospect of having it increased further appears to be limited at least in the short-run. So, there is not much choice left and expenditures have to be cut in several vital areas.

Rao, M.G., Tapas, K. Sen and M. Ghosh (1995)[24] have analysed in their study that after 1980-81, expenditure growth was higher than that of revenue receipts. Within total expenditure, revenue expenditure grew at rates higher than that of capital expenditure. Growth of revenue expenditure was particularly sharp in the case of interest payments, subsidies, wages and salaries, while those on maintenance of capital assets lagged behind. So fiscal imbalance becomes inevitable by the end of 1980s. The analysis also points towards the difficulty in achieving fiscal equilibrium in the short and medium term context. So long as the interest groups succeed in securing a large and increasing share of expenditures on categories beneficial to them, compression of fiscal deficit become difficult.

Chakraborty, P. (1997)[25] has attempted to examine whether the lowering the rates of direct and indirect taxes in recent years has resulted in higher tax mobilisation. The study concludes that compared to indirect taxes, direct taxes were more buoyant during the post-reform period. It has been observed by the author that generally reduction in tax rate cannot make a tax more buoyant instantly. There is a time lag involved.

Shome, P. (1998)[26] attempts to assess the state of fiscal stabilization in the post-reform period. He has shown that after an initial improvement in the fiscal deficit, the government faced difficulty in controlling the fiscal deficit/GDP ratio. The tax/GDP ratio also declined and the central government passed down certain expenditure repsonsibilities to state governments, thereby managing to reduce the expenditure/GDP ratio to some extent. His work focusses on the performance of the fiscal sector and the direction for future policy imperatives.

Mohan, R. (2000)[27] has analysed trends in state and central government revenues and expenditures and suggested ways to climb out of debt trap. He has observed that rapid economic growth is the only solution to the problem of poverty and such growth is not possible without significant fiscal correction. The key objective of fiscal reform has to be a reduction in public debt service payments.

Kopits, G. (2001)[28] assesses the potential usefulness of fiscal policy rules for India, in the light of rapidly growing international experience in this area. As part of his assessment, he explores various design options and institutional arrangements that seem relevant for India in the context of the Fiscal Responsibility and Budget Management Bill. He also outlines preparatory steps for successful implementation.

After reviewing the literature, we can say that there is wide agreement among economists that the problem of fiscal imbalance in many developing countries and particularly in India has emerged in the 1980s. And the factors responsible for the worsening of fiscal crisis were almost same in all of the developing countries. For example run-away expenditure coupled with stagnant revenues (along with lower share of direct taxes) and growing public debt with rising amount of interest payments.

1.7 OBJECTIVES OF THE STUDY

The objectives of this study are :

(i) to study the conceptual framework and the basic issues involved in the problem of fiscal stabilization,

(ii) to examine the background and causes of the inception of the problem,

(iii) to study the measures undertaken by the government for the restoration of fiscal stabilization,

(iv) to review the impact of the fiscal stabilization measures in the different dimensions, and

(v) to identify areas for further reform to restore sustainable fiscal stability.

1.8 SCOPE AND LIMITATIONS OF THE STUDY

The choice of the seventh plan or 1985-86 as starting point of the present study, is basically because problem of fiscal imbalance started worsening from this period. In the Indian economy a number of events took place during eighties and by the end of eighties the problem of fiscal stabilization reached to a dangerous level. This situation compelled the government of India to take some bold steps to restore fiscal stability in the economy. These events generated interest among the students of public finance to study the whole problem with a new approach.

It may be noted that 'Problem of fiscal stabilization' constitute a vast and dynamic field of the study. Scope of any study specially in social sciences is always limited and our work is not an exception. We have tried not to capture each and every factor rather concentrated on few selected factors. Therefore, despite all efforts to make this study up-to-date, comprehensive and analytical deficiencies are bound to remain.

1.9 DATABASE AND METHODOLOGY

Our study is based exclusively on secondary data which are published mainly by the Ministry of Finance, Government of India, other departments/offices of the government of India and RBI. Thus, most of the relevant data have been taken from various issues of Indian Public Finance Statistics', 'Economic Survey', 'National Accounts Statistics', 'Budget at a Glance', and 'Report on Currency and Finance'. Besides these sources we have also taken data from 'Public Finance Statistics' published by CMIE, Mumbai and 'Economic Development in India - A country report, published by the World Bank.

The methodology used here in order to identify and analyse the important factors which have contributed to the occurrance of the fiscal instability, does not go beyond simple statistical methods.

1.10 PLAN OF THE STUDY

The study is divided into six sections : In section 1, we have dealt with the Introduction of the study. This chapter covers the concept of fiscal policy and nature of the problem of fiscal stabilization. After that, survey of relevant literature has been undertaken. Second section is devoted to the conceptual framework and basic issues in fiscal stabilization. Causes of the problem, size of the deficit and quality of the fiscal stabilization measures have been discussed in this chapter. Section three covers problem of fiscal stabilization during the seventh plan period. Various tools of fiscal policy have been analysed in this chapter in order to identify the factors responsible for fiscal instability in the Indian economy. Section four attempts to review fiscal stabilization measures introduced by the government of India since 1991. In section five, effect of fiscal stabilization measures on the performance of various fiscal tools have been analysed. Finally, in section six, conclusions drawn from the study are made and some suggestions have also been put forward.

NOTES

i) For discussion of fiscal measurement issues, see Tanzi, V. et al. (1987) : "Inflation and the Measuring of Fiscal Deficits", Staff Papers, I.M.F., 34, pp. 711-738.

ii) Shifts of the deficit among different sections of the public sector can create difficulties in assessing the progress of fiscal stabilization programmes through the monitoring of fiscal ceilings.

iii) It requires a full estimate of domestic debt, a precise measurement of the rate of inflation, the assumption that expected inflation is equal to measured inflation and so forth.

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Chapter - 2

BASIC ISSUES IN FISCAL STABILIZATION

2.1 INTRODUCTION

Dealing with fiscal deficit remains one of the most vexing problem for the majority of developing countries. For many, growing fiscal deficits led to money creation as the main source of financing followed by rising inflation, an erosion of tax base, and even larger fiscal imbalances.

While the need for fiscal reform is now widely recognised, the experience of many countries indicates that fiscal reform is very difficult. The difficulties are partly political, partly institutional, and partly conceptual. Unfortunately, a not rare outcome is that countries often pursue fiscal reforms that are ad-hoc and inadequate, after some initial success, the situation relapses to a position at times more serious than the one that had prevailed before the adjustment.

Many of the issues that arise in pursuing fiscal stabilization can be conveniently discussed under five headings : (i) Fiscal trends - a look at the evidence, (ii) The Fiscal deficits, (iii) Effects of specific policy moves, (A) Fiscal effects of Devaluation, (B) Expenditure cuts, (C) Tax increases, (D) The Role of Domestic Debt, (iv) The quality of fiscal stabilization, and (v) The sequencing of fiscal reforms.

2.2 FISCAL TRENDS : A LOOK AT THE EVIDENCE

The immediate origins of the fiscal crisis was the assumption by governments of privately contracted debt. Governments also faced internal pressures caused by the effects of short-run adjustment (stabilization) policies involving sharp devaluations required to raise foreign exchange to service the external debt. The ensuing sharp depreciations of the real exchange rate helped to generate the needed foreign exchange but resulted in capital losses for foreign denominated debt holders.[1] As a result the external debt problem became first and foremost a fiscal problem.

Turning to fiscal revenues, they too have been insensitive to the fiscal crisis. Since the onset of the crisis, neither low income countries nor middle income countries have been able to significantly raise fiscal revenues. Moreover, both groups have registered a declining share of income taxes in total revenues. Direct taxes being typically the most progressive and buoyant component of the tax system, this trend may signal both, efficiency loss, and equity deterioration. For low income countries, trade tax revenues continue to be the most important source of tax revenue. With import growth effectively constrained by foreign exchange earnings, the reliance on trade taxes further reduces the buoyancy of the tax system for this group of countries. At the same time, the role of foreign grants in helping alleviate the crisis has been relatively small even for low income countries.

Stagnant revenues coupled with difficulties in compressing expenditures, implies limited progress towards reducing fiscal imbalances. With foreign borrowing foreclosed, this meant that governments had to rely on domestic sources of financing. For countries with relatively underdeveloped capital markets, borrowing from the central bank was the only remaining option. The ensuing increase in liquidity could only result either in run away inflation, or in capital flight, or a combination of both.[2]

The debt and fiscal crisis combined to force many countries to undertake adjustment programmes. Fiscal policy came to be an essential component of adjustment programmes. On the one hand the recovery of fiscal discipline was viewed as a pre-requisite for fiscal stabilization, On the other hand, the reform of existing fiscal incentives.

2.3 THE FISCAL DEFICITS

Fiscal difficulty is conventionally defined as a large and/or increasing public sector deficit. To start with, how does a government get into fiscal difficulty has to be understood. Three views predominate in the literature. They can be labelled as political deficit, the structural deficit, and the inflation tax approaches respectively.

Blaming political forces for fiscal expansion is an old tradition in economics, shared by conservatives such as Schumpeter[3] and radicals like O'Connor[4] at different places and times. The general view is that to maintain its political legitimacy, the state is forced toward taxing too little or spending too much, both to pay off specific interest groups and to sustain the level of employment via aggregate demand. This policy bias leads ultimately to increasing external deficits and/or inflation, requiring stabilization through deficit reduction sometimes in long run.

In one example of this line of thought, the Mexican crisis after 1982 is attributed by some analysts to politically driven expansion by a government which overestimated its spending power from the oil and foreign borrowing booms of the nineteen seventies. Inflation did not accelerate dramatically until after 1982, but before that unsustainable levels of imports were said to be the result. Finally, politically directed redistribution plus expansionary fiscal policy in the stagnationist economy of Chile stimulated output to the point at which capacity limits bound, triggering inflation and external imbalance.

Structuralist economists are by no means opposed to invoking politics to explain deficits, but also suggest other reasons for them to exist. One is an external shock-falling terms of trade, an export supply shortfall, or an interest rate excrusion on external debt. Such shocks are contractionary most government try to offset them in the short-run by fiscal means. Casuality runs from the external to internal deficit leads to reversal of the usual political link.[5]

Besides external shocks, other structural factors may force fiscal expansion. They include natural disasters, financial turmoil, ongoing inflation with government debt, and foreign payments obligations.

The disaster scenario is familiar. It requires little comment beyond the observation that relief efforts have both a supply and demand dimension. Not only must commodities be supplied to victims, they must also be in demand. For example A.K. Sen[6] attributes famine largely to a demand collapse induced by rising food prices in the face of fixed nominal incomes. Restoring demand involves fiscal deficit spending to transfer income to the groups hit hardest by the price increases.

Financial collapse lies at the root of many stabilizations. The typical scenario begins with a surge in speculation involving shares and/or real estate. A bubble is most likely to blow itself up when potential saving is high, productive investment outlets do not seem to be available, and when deregulation of the financial system opens possibilities for manipulation. This situation reminds us of recent experiences in East Asian countries.

The collapse leaves firms and banks with badly compromised balance sheet positions. The subsequent bail-out involves fiscal outlays and heavy rediscounting by the central bank of commercial bank loans. The government may also issue its internal obligations in exchange for the private sector's foreign debt, and may have direct problems with the balance sheets of public enterprises. Finally, disruption in local financial markets provoks capital flight. It tends to be more serious under deregulated financial regimes in which exchange controls have been weakened or removed. Most of these interventions increase the state's deficit.

The next structural case of a fiscal deficit is monetary indexation under continuing inflation. Structural inflation theory argues more from the side of costs than demand, emphasizing distributional conflict and indexation mechanisms. An initial price excrusion say from a supply shock, a period of forced saving in response to expansionary policy or an increase in local spending power as from an export price increase, or a cost shock such as devaluation, reduce some income flows in real terms. The shock marks the first stage of inflation.

If inflation is structural, it steadily erodes the real value of the money supply, the inflation tax begins the bite. One way to avoid this problem is to index money by paying interest on all state obligations. In principle, such a policy is fiscally neutral. The inflation tax cuts demand and interest payments on government debt offset the tax. However, when inflation reaches triple digits, nominal government outlays for interest payments soar.

2.4 EFFECTS OF SPECIFIC POLICY MOVES :

The above discussion suggests that fiscal deficits have numerous causes; not all deficits are irrational, and not all add to aggregate demand. Nonetheless, deficit reduction is the main objective of orthodox stabilization packages of the type usually proposed by the World Bank and IMF. How does such austerity affect the economy's chances of achieving normal policy goals ?

Most governments share at least four eocnomic targets :

* to maintain socially acceptable levels of capacity utilization and growth, especially in sectors and regions dominated by their political base,
* to keep inflation down to a rate tolerable in terms of the country's own history of price increases,
* to alter wealth and income distributions in line with the regime's ideological predilections and political constraints, and
* to maintain a degree of self-reliance in trade and external financial relationships.[7]

The question at hand regards the likely effects of fiscal and other measures under such circumstances. There are several relevant policy linkages;

First, one must be aware of specific effects of different policies. As we have seen, cutting public investment may also lead private capital formation to decline. Increasing indirect taxes will drive up costs, possibly accelerating a structural inflation. Successful anti inflation policies are likely to lead to more efficient tax collection as the effects of payment lags on real revenues are reduced. Hence, more fiscal demand contraction may occur than had been planned.

Second, inflation reduction will have other macro effects that have to be taken into consideration. Monetary correction was never completely effective. As a consequence, dramatically slower inflation made velocity fall or money demand rise. Room was opened for money creation, either by fiscal deficit spending or reserve increases from capital inflows. Reducing inflation also got rid of the inflation tax. The fiscal restraint implicit in more effective direct and indirect tax collection was offset by the expansionary effect of undoing the erosion of real wealth by steadily rising prices.

Third, prices charged or offered by public enterprises are an important component of fiscal policy in many countries. Changes in prices charged for essential services or food may have strong distributional repercussions. If public enterprises sell intermediate goods, then increasing their prices will have ambiguous effects on inflation.

Producer's costs will rise. They may well pass them along to final commodity prices, provoking structural inflation. On the other hand, the consolidated public sector deficit will be reduced, leading to less state borrowing from the central bank and money creation. The inflation rate may decline for monetarist reasons.

Manipulations of consumer prices, for example, via food subsidies can also have important fiscal and balance of payments effects. With supply elasticities in the usual empirical range, for example, an increased subsidy rate on food purchases will create inflationary pressure unless stocks are run down or imports brought in to meet the additional demand the subsidy creats. If new supplies do not materialize, then prices will go up enough to offset both the direct demand increase and the fiscal injection it embodies.[8]

Fourth, the observation is that fiscal measures should not be undertaken independently of other policy moves. Devaluation, for example, may at times lead to output contraction in developing economies through well known channels.[9]

Fifth, fiscal measures may substitute for other policies. Devaluation stimulates, but so do favourable producer prices and/or subsidies. The latter, directed interventions do not share devaluation's unpleasant economy-wide effects and may well be the preferred option for the reason.

Finally, the fiscal position will influence private actions in external capital market. Restrictive policy makes repatriation of flight capital or emigrant remittances more likely by bidding up interest rates. On the other hand, financial incentives alone are not likely to draw external resources toward stagnant economy.

2.4.1. Fiscal Effects of Devaluation

Devaluation is also likely to have fiscal effects. First is the capital loss resulting from a real exchange rate depreciation. Consider the case of a small debtor country. Most of its foreign debt is in the hands of the public sector. This is a realistic feature of most highly indebted developing countries. The economy faces a double transfer problem, resources must be transfered abroad to service the foreign debt, but first the public sector must obtain the required foreign exchange from the private sector. A real depreciation, i.e. a fall in the relative price of non-traded goods, will facilitate the external transfer, but may exacerbate the problem arising from the required internal transfer.[10] Consider the case where non-traded goods are a net source of revenue for the government. A real depreciation will then worsen the governments terms of trade with respect to the private sector. If the government relies at the margin on a distortionary tax to meet its revenue needs, it will need additional revenue with detrimental effects on the economy. Debt service therefore entails a "secondary burden", beyond the resource loss caused by transfering resources abroad, because of deteriorating internal terms of trade.

2.4.2. Control of Public Expenditure

Stagnant economic growth and the limited progress toward fiscal stabilization, in particular the inability to raise significantly government revenues, brought to the forefront the need to introduce radical reforms in developing countries' fiscal systems, with the dual objectives of improving resource allocation and avoiding indiscriminate expenditure cuts.

Widespread reforms could no longer escape the issue of which expenditures to cut and which taxes to raise. Public investment took the brunt of expenditure cuts. How to evaluate a reduction in capital expenditures is a difficult, and yet, largely unresolved issue. On the one hand, inefficient public enterprise investments can, and should be, cut. On the other hand, public sector investments that generate externalities and that are largely complementary with private sector investments should be maintained.

Most experts agree that current expenditure should also share some of the cuts. They often disagree, however, on the distribution of these cuts across expenditure categories. Vito Tanzi[11], for instance, agrees that cuts in public employment should be preferred to reduction in public wages. His argument is that the latter are not sustainable and will be soon reversed when the economic emergency subsides. Also, wage cuts may lead to loss of motivation and lower productivity.

Cornia and Stewart[12], on the other hand tackle the issue from an equity point of view. They argue that cuts in public wages will not have a regressive distributional impact to the extent that public employees belong to the upper middle income scale. Instead reductions in public employment are likely to reduce the provision of public services with a negative impact on the poor.

A further area of disagreement involves the extent to which consumers' subsidies should bear the consequences of fiscal restrains. Finally, all agree that military expenditure should not be spared.

On the basis of empirical evidence, it is said that poverty alleviation and fiscal expenditure discipline are not incompatible. The issue arises at two levels. First, regarding the intersectoral allocation of public expenditure. Second, is the issue of the intersectoral allocation of public spending.

In recent fiscal stabilization programmes expenditure reductions have been more significant than revenue increases. However, the approach followed in cutting expenditures has been far from efficient.

If public sector wages are high in comparison of the private sector, their reduction could be part of a fiscal stabilization package. Real wages can obviously be reduced quickly and can, thus, result in rapid expenditure reductions. Over a longer period, however, it is the size of the public sector workforce that will be the major determinant of public expenditure for wages and salaries. The reduction of public employment is difficult and may even be financially costly in the short-term, but it must be pursued vigorously if a durable stabilization is to be achieved. Over the long run, this effort will pay off.

The second important category of public expenditure that must receive early attention is the investment budget. A close evaluation of all the planned as well as the ongoing projects is necessary. Projects planned for the period ahead but not yet initiated, should be carefully scrutinized regardless of whether they have foreign financing or not. Only if their expected rate of return is very high they should be retained.[13] For the ongoing projects, considerations of sunk costs will be important as well as costs associated with the process of stopping these projects and restarting them at a later time. In some cases this stop go can be very costly.

The third obvious expenditure area for close scrutiny and quick expenditure reduction is subsidies. Some subsidies may be very important to the poorest groups and must be retained. Others could be important in subsidising activities that generate significant positive externalities. When subsidies are of a general nature and especially when they encourage the consumption of a traded good the existence of inefficient enterprises, they must be cut.[24]

Obviously, the defence budget must not escape close scrutiny Unfortunately, this expenditure has been very resilient during stabilization programmes so that one should not be excessively optimistic. But the government should attempt to put downward pressure on this spending.

In most countries there are many activities which for historical or political reasons have been taken over by the government, perhaps for reasons that appeared legitimate at the time. Vested interests and pressure groups will argue for the status quo but a determined government with a clear sense of direction can show the absurdities of many regulations and governmental activities and can make a concerted effort to get rid of many of them.

2.4.3. Tax Reforms

Equity and efficiency issues arise also in the design of taxation reform. Usually the stimulas for tax reforms came from large and unsustainable fiscal deficits. Tax system in many developing countries was heavily influenced by their colonial legacy. This influence was reflected in a very complex tax structure with emphasis on progressive income taxes. Other major features of typical tax systems included : a cascaded structure of indirect taxes; a schedular system for direct taxes; and, a proliferation of exceptions and exemptions. The resulting system were much too complex for the administrative capabilities of developing countries. They encouraged too many arbitages which eroded the tax base. A lack of constituency in favour of tax reforms and the existence of powerful vested interests in support of the status quo perpetuated the existing system untill large fiscal deficits provided the required stimulus for tax reforms.

Recent experience of a number of developing countries shows how tax reforms were typically designed to minimise the incentive for tax avoiding resource shifts. They did so by applying the company tax to all forms of business organization, by aligning personal and corporate tax rates, by broadening the personal and corporate tax bases, and by mitigating the tax bias in favour of debt finance.[15] Other major features of the reformed systems included the lowering of direct tax rates, the introduction of a value added tax and extensive inflation adjustment measures.

A perhaps more fundamental issue is the basic inspiration behind tax reforms. Optimal taxation theory concludes in favour of non-uniform tax rates. Also, equity motive may clash with the desired for simplicity. An equitable system may indeed require sophisticated distinctions. Again the issue is difficult to settle, in so far as complex tax systems tend to offer a wide set of opportunities for tax evasion that benefit rich people. Yet, a larger weight to the equity motive in the design of tax reforms seems warranted.

A measure that can be introduced relatively quickly and can have several beneficial effects in addition to providing additional revenue is an increase in public utility tariffs. However, it is important, to take steps that prevent the benefits from the increase form being dissipated in higher salaries, higher employment or in unnecessary investments by the public enterprises. If the central government is unable to control the behaviour of the public enterprises, only their privatization might reduce the fiscal disequilibrium. Provided that the spending by the public enterprises can be controlled, the tariff increase can be larger than it would be necessary if other measures were in place. For a while, the government can exploit the monopoly power of these enterprises to raise needed revenue.[16]

If the government is able to legislate the needed changes quickly, on the revenue potential of particular excises should be fully exploited. Increases in taxes on tobacco, alcoholic beverages, and a few other commodities can be justified on various efficiency grounds. But once again the initial increases must be protected against the eroding influence of future inflation. Once again untill the fundamental reforms are in place, these excises can be made to generate more revenue than might be desired over the long run. On the basis of information as to the demand elasticity of these products, taxes that would maximise their revenue generation could be imposed.

Some administrative changes for raising tax revenue in the short-run can also be considered. For example, in situations of high inflation, collection lags can be shortened administratively. This reduction can raise revenue by significant amounts.[17] Tax evasion can be reduced by the judicious use of penalities. Postponement in tax payments can be discouraged by raising steeply, to a high positive level, the interest charges on delayed payments.

The introduction of a value-added tax (VAT) with the widest base and with possibly one rate should be a central element of a fundamental reform. Studies on the estimation of the size of the potential VATbase will be necessary in order to determine the rate required to raise the desired revenue. The introduction or the broadening the scope of the VAT will often have beneficial effects on revenue from other taxes and especially from the income taxes.

The reform of income taxes (personal and corporate) will also require time but less than the introduction of a VAT. Most developing countries already have income taxes so that it will be mainly a matter of modifying the existing structure. For the personal income tax, the main policy changes will concern : (a) a reduction in the often very high level of personal exemptions; (b) the elimination of many deductions and special treatments of particular income; (c) a change in the rate structure probably by raising the first rate at least 10 per cent if it is lower, and reducing the highest rates to perhaps the 30-40 per cent range after careful analysis; (d) the forceful use of presumptive taxation in connection with hard-to-tax activities. A serious effort should also be made to improve the administration of these taxes by relying on all the information available to the government to reach potential tax payers and to determine their income.

Changes in corporate income taxes can also be introduced relatively quickly although as for taxes on the income of individuals, the revenue effects may not be felt for perhaps two years. The basic changes relate to wipe out the tax base; the lowering of the rate; and better administration. In some recent reforms, these minimum taxes have been based on (a) the imports of corporations; (b) their turnover; and (c) their gross assets.

Changes in import taxation can also be made relatively quickly once the legislation is approved. The most important and quick change would be the imposition of a minimum tax on all imports. This change would also improve the efficiency of the economy by reducing the dispersion in effective protection.

2.4.4. Public Debt

The fiscal deficit constitutes most important link between fiscal policy and indebtedness. It was suggested that the existing debt level is sustainable if it is being fully serviced. Whereas this rationale is an over-simplification of the concept of sustainability and in particular does not identify Ponzi financed debt as unsustainable, it does imply that countries receiving external debt relief are in a situation of 'excess' debt.[18] That is, the current debt level is higher than the sustainable one. Relief on external debt is typically provided in the face of a balance of payments crisis, and so the existence of excess external debt can be identified with the lack of foreign exchange for debt servicing. A sustainable foreign debt level would be one that could be financed within a realistic balance of payment scenario.

A determination of excess domestic debt is more tricky. The definition of sustainable debt as freely marketed government debt is appealing but would imply unrealistically low domestic debt ratios for most countries in the medium term. An alternative is to include sustainable domestic debt that is mobilised by long standing institutional arrangements with domestic financial institutions. Government doemstic debt that results from exceptional financing schemes, such as arrears or domestic loan counterparts to IMF credits, would be excluded and considered excess debt.

Once a 'sustainable' deficit has been achieved and the 'excess' debt has been paid off, a country may want to move toward a 'desirable' debt, which would be lower, and a compatible 'desirable' deficit. Criteria for setting the desirable debt level might include primary reliance on voluntary placement of government debt at moderate real interest rates and limits on foreign debt servicing as a percentage of exports and/or government revenues.[19]

The cost of a 'desirable' deficit would be higher taxes or lower expenditure during the stabilization period. The rewards would be : (i) a more comfortable budgetary debt service burden, (ii) less pressure on the balance of payments and the exchange rate, as a result of the lower external debt burden, and (iii) lower domestic interest rates and/or more credit available for private sector investment.

On average, the estimated sustainable deficits were higher for the high-debt countries than for the low-debt countries. Thus, although substantial fiscal adjustment was undertaken in both groups, low debt countries exceeded their sustainable deficits during this period by more than high debt countries. Their fiscal position contributed, in turn, to their relatively faster accumulation of total foreign debt.

In some respects, the similarities between the two groups are as interesting as the differences. Both groups faced similar real interest rates on foreign debt. And both groups experienced similar growth rates in real GDP - a factor that can be at least partly explained by the stimulating effect on GDP of the export drive in several countries included in the high-debt group and the depressing effect on GDP of the export slump in several low-debt countries. The favourable export drive in the high debt countries helped to offset the depressing of debt overhang and high real costs of foreign borrowing. Meanwhile, the poor export performance in the low debt countries was partly offset by the stimulating effects of foreign capital inflow.

2.5 THE QUALITY OF FISCAL STABILIZATION

The focus of this section will be upon the kind of fiscal stabilization that a country should introduce. In recent years we have become progressively more aware of the fact that a given reduction in the fiscal deficit may be genuine and of good quality or of a largely cosmetic kind and of poor quality. The economic effects of the two are likely to be widely divergent. Unfortunately, cosmetic changes are often easier and politically less costly to make. This fact, coupled with the realization that the time horizon that is most important to policy makers often leads to a preference for cosmetic over genuine adjustment. Policy makers tend to follow the line of least resistance.

A reduction of certain magnitude in the fiscal deficit is in most cases, not the result of a single policy decision as would be, say, a devaluation or an increase in interest rates but the summation of many specific policy decisions, both on the revenue side and on the expenditure side.[20]

A high quality fiscal stabilization must be associated with measures that individually are efficient, durable, and equitable. In other words, these measures must not introduce avoidable distortions; they must not self-destruct in the near future; and they must not eliminate expenditures that are important for economic or social reasons when alternatives are available. The public spending to be reduced must be the one that contributes the least to the efficiency and the fairness of the economic system.

On the revenue side, and broadly in order of preference but not in order of facility of introduction, the following measures could be chosen : First, the broadening or the introduction of a general consumption tax, possibly one with characteristics of a value-added tax. Value added taxes are now important sources of revenue in a relatively efficient way and with relatively short lags.

Second, the government should fully explore the revenue possibility of excise taxes. These excises should be imposed on commodities with inelastic demand, or on those whose consumption generates substantial negative externalities. Third, important changes can be introduced to the personal income tax. Personal income taxes contribute still very little to total revenue in developing countries. If basic changes are made, the threshold of the tax can remain generous, and high marginal tax rates can be cut, without much revenue loss and with potential gains in work effort and tax payers' compliance.

For taxes on corporations, similar considerations apply. Corpórate income taxes are often eroded by excessive incentives and complex laws. In particular circumstances, and especially when the rate of inflation is high, alternative forms of taxing corporations may need to be introduced.

The next measure, which especially in the short run can be very important from a revenue point of view, is the raising of public utility prices and the introduction of user charges for particular services provided by the public sector, such as higher education and health. The real prices at which electricity, water, telephone, transportation and other public sector services are sold normally fall, at times quite drastically, during inflationary periods. This fall increases the demand for these services. Because of losses experienced by the public enterprises, it becomes difficult to expand capacity. Enterprises have also difficulties in providing the funds necessary for operation and maintenance, especially in view of the more intensive utilization of their plants. Thus, capacity will decline and the quality of the service will deteriorate. The greater is the fall in the real tariffs charged by the public enterprises, and the greater is the demand response to that fall, the greater will appear to be the need to expand investment in those activities. Thus, an artificial justification for capacity expansion will be created especially at a time when the resources to satisfy that expansion are sharply reduced.[21]

A correction of these prices will thus : (i) generate more revenue; (ii) reduce the need for additional investment to expand capacity by lowering demand; and (iii) by reducing overuse, it will reduce maintenance costs. Finally, imports can be made to generate larger revenues either by dismantling quotas and other quantitative restrictions and replacing them by import duties or by removing the excessive erosion of the import tax base created by incentives and special exemptions, and by introducing a minimum tax on all imports. In both cases the additional revenue would be accompanied by improved efficiency. On the expenditure side, a variety of steps can be taken :

First, and most importantly, unproductive investment projects must be eliminated. The argument often heard that investment must be protected during adjustment is simply misguided. While productive investment is an important source of growth and must be protected, unproductive investment especially if associated with imported machinery and capital equipment, is a major burden on the economy. In most developing countries the investment budget is padded with many politically motivated and unproductive investments which can, and should be eliminated. Unlike consumption expenditure, it may contribute little to the welfare of the country's citizens.[22]

Furthermore, if it is obtained with foreign credit, it becomes a long-term drag on the economy. Hence, unproductive investment must be the first area where cuts should be made. Some of the saving from this source could be allocated to operations and maintenance expenditure, which would increase the efficiency of the existing capital structure and would permit that structure to support a higher level of income.

A second area where reductions could be made is in the wage bill of the public sector. During stabilization many countries have in fact, attempted to reduce the wage bill of the public sector. However, policy makers have generally preferred to reduce real wages rather than public employment. There is evidence, from some countries, that cuts in real wages have been even accompanied by expansions in public sector employment. Since the marginal cost of hiring extra workers falls with the fall in real wages and since adjustment often increases unemployment in the short-run, pressure is put on the government to be the employer of last resort. Such a policy does not have much chance for success in reducing the wage bill over the long run and it is likely to increase the inefficiency of public sector employees, especially at a time when the public sector is expected to play a larger role in restructuring the economy. The cut in real wages, unless they were high to start with, almost guarantees that the efficiency of the public sector will fall. Furthermore, a drastic fall in real wages guarantees that they will bounce back as soon as the government is no longer able to withstand the pressure of public sector unions.[23] In other words, excessive reduction in real wages will increase fiscal tension. The reduction in real wages, at a time of high unemployment, will generate pressures on the government to increase its employment. In many developing countries the public sector is clearly overstaffed. Therefore, fiscal stabilization that hopes to reduce the wage bill permanently must reduce in some cases quite considerably, the number of public employees. This may require privatising some activities.

The third important area for reduction, although a politically difficult one, is defence expenditure. Defence expenditure remains excessive in developing countries. Unfortunately, this spending has been able so far to withstand the downward pressures in public expenditure that accompany stabilization programmes.[24]

Fourth, many countries engage in various forms of unproductive expenditure, from the building of monuments to the subsidization of unnecessary activities. In many developing countries, for example, a large number of public cars (often expensive ones) are purchased. In many of these countries the enforcement of useless regulations also requires substantial public sector resoruces. Reducing some regulations will reduce public spending. In conclusion, in most countries there is scope for pruning the budget of many of these activities. Subsidies must be closely scrutinized. Those which are essential, because of social objectives, or because of significant externalities, should be protected. But generalised subsidies, provided through the artificial reduction in the prices of products of general consumption, should be eliminated. Many subsidies, even when defended on the grounds that they protect the poor, just subsidise the middle classes.

2.6 THE SEQUENCING OF FISCAL REFORMS

A fundamental and common conflict that arises in adjustment programmes is the one between the need to achieve quick results and the time necessary to develop, legislate, and implement sound policies. The need for quick results is often promoted by : (a) the precariousness of the economic situation; (b) the fear that if changes are not made immediately, they will not be made; and (c) by arrangements with international institutions which are often time constrained.

While changes in interest rates, in exchange rates, and in other areas of economic policy can be made relatively quickly and often do not require legislative approval, good fiscal reforms, that include tax reform, public sector reorganizations including privatization, reform of public expenditure programmes, and so forth, require time and, in many countries, must be legislated. As a consequence, countries have often gone for 'quick fixes' that is for fiscal reforms that reduce the fiscal deficit in the period immediately ahead with policy changes that are neither durable nor efficient. Common elements of these 'quick fix' solutions have been : (a) sharp reductions in public sector real wages to levels below their likely long-run equilibrium; (b) sharp and indiscriminate cuts in investment expenditure without much assurance that the projects that are eliminated are least productive; (c) sharp cuts in expenditures on operation and maintenance leading to a faster deterioration of the existing capital infrastructure and to reduce capacity utilization; (d) emergency tax legislation, including the temporary introduction of very distortionary taxes such as those on exports and financial instruments, and of temporary surtaxes on import duties, income taxes, and others; (e) excessive increases in some excises; (f) anticipation of tax payments, sometimes by providing discounts for anticipated payments to tax payers, thus reducing further tax collection; (g) tax amnesties; (h) quick sales of some assets; (i) delay in making payments, (j) various imaginative maneuvers aimed at 'parking' the deficit in parts of the public sector not covered by the programme.

Most of the above measures are either self-destructing, or of questionable quality, or both. They are not the kind of measures that one would want in a good programme or that will result in durable stabilization. They will cause a rise in fiscal tension, increasing uncertainty and sending negative signals to investors, thus discouraging capital repatriation, or encouraging capital flight. Given the measured fiscal deficit, the expected rate of return on private investment is likely to be negatively related to the degree of fiscal tension while private investment is positively related to the expected rate of return. Therefore, a deficit reduction acheived through these means should not be expected to bring about an improvement in economic conditions. Such a reduction can only be justified if it is clearly announced and believed to be a transitory step toward a more durable and higher quality package. Unfortunately, these measures often exhaust the political will of the government to make the more basic reforms or are seen as the only way to reduce the fiscal deficit.

Sustainable fiscal policy requires, almost by definition, measures that will survive the test of time and that will not put additional impediments on the efficient allocation of resources. It must involve good macroeconomists working in close cooperation with public finance specialists experienced in both policy and administration.

This chapter has surveyed some major issues that arise in trying to bring the fiscal situation of countries under control. It emphasised the much greater complexities and difficulties that arise in the fiscal area as compared to other areas of economic policy. In recent years there has been a lively discussion among economists and policy makers on whether countries should go for shock therapy or for gradualism. This, however, is not a meaningful debate if applied to fiscal policy since as argued above, good fiscal measures always require time.

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Chapter - 3

PROBLEM OF FISCAL STABILIZATION IN INDIAN ECONOMY DURING SEVENTH PLAN PERIOD (1985-86 to 1989-90)

3.1 INTRODUCTION

The fiscal situation which was under strain throughout the 1980s, reached a critical situation in 1990-91. The unabated growth of non-plan expenditure and poor returns from investments made in the public sector have been the main contributory factors in the fiscal crisis. There has been a steady decline in the share of capital formation in the central government expenditure. The gross savings of the government which turned negative for the first time in 1984-85, continued to remain so. The fiscal imbalance also manifested in a sharp increase in internal debt and resultant increase in interest payments.

The fiscal situation which had been under mounting pressure throughout 1980s assumed crisis proportions by the begining of the fiscal year 1991-92. The Gulf Crisis of 1990 added fuel to the fire. Throughout the eighties, all important indicators of fiscal imbalance were on the rise. These are the conventional budgetary deficit, the revenue deficit, the monetised deficit and gross fiscal deficit. Such a fiscal situation has become unsustainable.

This chapter addresses the problem of fiscal stabilizaiton in Indian economy in a practical way. In part II, it highlights the trends in revenue reciepts. Part III examines the growth of expenditure. Part IV deals with the contribution of public sector enterprises in the worsening of the fiscal situation. Finally, it highlights the emergence of fiscal imbalance.

3.2 TRENDS IN REVENUE RECEIPTS

3.2.1 Performance of Taxes

The objectives of the fiscal policy and tax structure should be based on the foundation of "equality, certainty, convenience and eocnomy". These old maxims of taxation are well accepted standards for a tax system. If a tax system is not properly structured and administered on the above standards it either causes undue hardship to the public or discrimination in the tax burdens or uncertainty in the revenue receipts.[1]

A brief review of the Indian fiscal policy during the past 5 decades clearly indicates the attempts for obtaining more tax revenue to the exchequer. By a process of both widening and deepening of the tax base, the combined tax revenue of the centre, states and union territories increased during this period. The tax revenue/GDP ratio went up. The combined revenue receipts (tax revenue plus non tax revenue) have also witnessed a similar increase (Table A-1).

But with this impressive increase in tax and non-tax revenues, some important features accompanying this rise should also be noted which are rather disconcerting :

(1) There has been a continuous decline in the share of direct taxes in the total tax revenue till mid nineties. It is certainly a very unhealthy development. This suggests how inequitable our tax system has become over the years.

(2) Our tax system, particularly, indirect tax system has led to large-scale

TABLE : A-1

REVENUE RECEIPTS OF THE CENTRAL GOVERNMENT (1980-81 to 1990-91)

(Rs. Crore)

•	1980-81	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Revenue Receipts	11937	28035	33083	37037	43591	49996	54954
A. Gross Tax Revenue	13149	28670	32838	37666	44474	51636	57576
(I) Direct Taxes	2966	5563	6236	6742	8783	9924	11030
(i) Corporation Tax	1377	2865	3160	3433	4407	4729	5335
(ii) Income Tax	1440	2511	2879	3192	4241	5004	5371
(II) Indirect Taxes	10183	23107	26602	30924	35691	41712	46546
(i) Custom Duties	3409	9526	11475	13702	15805	18036	20644
(ii) Excise Duties	6500	12956	14470	16426	18841	22406	24514
B. States's and UTs Share or Tax Revenue	3791	7530	8519	9651	10723	13287	14598
C. Non Tax Revenue	2579	6895	8764	9022	9840	11647	11976
(i) Interest Receipts	-	4595	5353	5755	6981	8466	8730
(ii) Dividends and Profits	-	515	507	605	475	716	774
(iii) Other Non-Tax Revenue	-	1785	2904	2662	2384	2465	2472
Non Tax, Revenue as a Percentage of GDP	1.9	2.63	3.00	2.71	2.48	2.55	2.24
Non Tax Revenue as a Percentage of Revenue Receipts	21.60	24.59	26.49	24.36	22.57	23.30	21.79
Interest Recipts as a Percentage of Non-Tax Revenue	-	66.64	61.08	63.80	70.94	72.70	72.90

Source : Government of India, Ministry of Finance, Budget Documents, and Indian Public Finance Statistics, Various Issues.

distortionary effects. The share of indirect taxes in the total tax revenue is much higher than that of industrialised countries and also appreciably higher than the average share for most developing countries. Our indirect tax system has not evolved as an integrated system as in developed countries. In a scramble for revenue, all types of products; raw materials, intermediate products and final products, that is, inputs as well as outputs have been brought under the direct tax net. Further, the various indirect levies fall mostly on the very same products. This has resulted in cascading effect causing an escalation of costs and profits at each stage.

(3) There is rampant tax evasion of both direct and indirect taxes leading to the generation of black money. It is often said that tax evasion is neither a new phenomenon nor a peculiar Indian problem. The Taxation Enquiry Committee, the Kaldor Report on Indian Tax Reform, the Wanchoo Committee and the NIPFP have attempted to quantify the extent of evasion and the magnitude of black money. The Wanchoo Committee states that the high rates of taxation under direct tax laws are the first and foremost reason for tax evasion in India. In the words of the committee : "An overwhelming majority of persons have voiced the opinion that tax evasion is dependent on the rates of taxation and rises with increases in the rates. Most of the economists have also subscribed to this view. Even those who did not concede that high rates led to evasion admitted.... that high rates did make tax evasion much more attractive and profitable".[2]

Gupta and Gupta also come to a similar conclusion. They state that, "rising average tax rates are associated with an increasing relative size of the underground economy. For instance, when average tax rates,.... increase by 1 per cent, the size of the unofficial economy relative to official economy increases by 3.16 per cent".[3] The unsanctioned economy has grown due to high taxes not only on income but also on commodities.... high income and corporation taxes create incentives to evade and avoid them. With high excise and sales taxes, incentive exists to produce and sell outside the purview of the official market.

(4) It is improtant to note that the growth of revenue from any tax may be viewed in two ways. One is the increase in tax receipts as a result of every increase in national income without any change either in the tax rates or in its coverage. It is known as the built-in-flexibility of the tax or simply the income elasticity of the tax. In the second case, changes in rates and coverage of the tax are also taken into account. In this case the growth in tax revenue is the result of a process of both widening and deepening of the tax. The two together account for the total increase in the tax yield and is known as the buoyancy of the tax.

The overall elasticity of the Indian tax system was 0.833 recorded by Sahota[4] for the period 1950-51 to 1957-58. It was 0.827 according to the estimates of V.G. Rao[5] during 1960-61 to 1973-74. These figures suggest that the income elasticity of Indian taxation has remained almost constant from 1950-51 to 1973-74. There are some indications to suggest that there has been a further decline in the responsiveness of our tax system. One such indicator is the estimates of buoyancy and elasticity of major indirect taxes recorded by M.M. Sury.[6] According to Sury, the buoyancy coefficient of union excise revenue was 3.02 during 1950-51 to 1964-65. It declined to 1.31 during 1963-64 to 1974-75. The elasticity coefficient reflects a lack of inherent response of excise revenue to changes in national income. If this is the case with the fastest growing central tax, it can very well be imagined what must have happened with other taxes, particularly, the direct taxes whose elasticity has always been the lowest.

3.2.2 Tax Structure and Revenue Productivity

The revenue yielding capacity of a tax structure is measured in terms of tax buoyancy and built in revenue flexibility. Tax buoyancy measures the total increase in tax revenue with respect to national income as a result of discretionary measures like increase in tax rates, introducing new taxes or increasing coverage of a particular tax etc. Tax buoyancy is also indicated by tax income ratio ...... the part of national income which is taken by taxes.

3.2.3 Tax Buoyancy

Tax buoyancy which is measured by tax-income ratio depends upon so many factors but the per capita income of the country is its main determinant. Tax-income ratio in India is much lower than in the economically advanced countries like USA, U.K. and Denmark etc., where it ranges from about 25 per cent to 45 per cent considering the fact that per capita income in India is much lower in comparison to these countries but such a high tax-income ratio may not be expected in India. In view of the increasing financial requirements for the planned economic development in the country tax-income ratio should at least range between 20-25 per cent of national income.

3.2.4 Trends

A feature of India's tax structure during the sixth and seventh plan period was the preponderance of indirect taxes. As Table (A-2 & Figure a-i) shows, the proportion of indirect taxes in the tax revenue collected by the centre has increased steadily over the years, from 77.26 per cent in 1980-81 to 80.28 per cent in 1984-85 and 82.1 per cent in 1987-88. Indirect taxes increased on an average from 77.4 per cent of total tax revenue during the sixth plan period to 80.95 per cent during the seventh plan period. The proportion of direct taxes has declined correspondingly from 22.6 per cent during the sixth plan period to 19.05 per cent during the seventh plan period.

Among the direct taxes, the share of non-corporate, that is personal income tax has remained stagnant, it started out at 9.1 per cent during the sixth plan period, and reached to 9.56 per cent during the seventh plan period (Table A-2 & Figure a-i) while that of corporation tax registered a decline from 11.6 per cent during the sixth plan to 9.04 per cent during the seventh plan period. The decline in the share of direct taxes has occurred during this period despite high rates of tax.

Among indirect taxes, the proportion of union excise has come down from an average of 47.6 per cent during sixth plan to 43.72 per cent during seventh plan period (Table A-2 & Figure a-i) and that of customs has increased from 27.8 per cent to 35 per cent during the period under reference. During the same period the share of direct taxes to indirect taxes has declined from 27 per cent to 25 per cent (Table A-4 & Figure a-ii).

TABLE : A-2

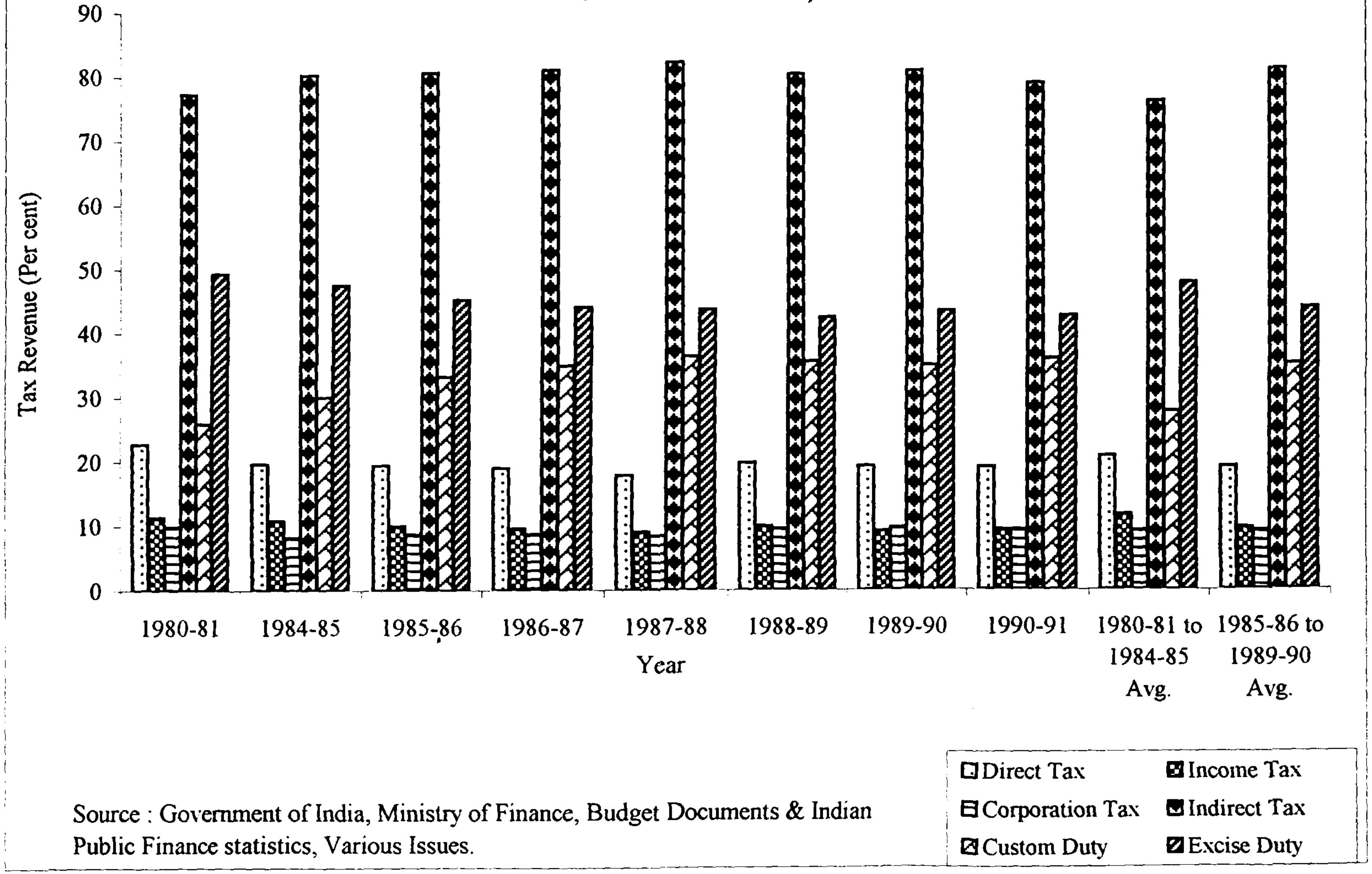
COMPOSITION OF TAX REVENUE OF THE CENTRAL GOVERNMENT 1980-81 to 1990-91 (Per cent of Gross Tax Revenue)

Year	Direct Tax	Personal Income Tax	Corporation Tax	Indirect Tax	Custom Duty.	Excise Duty.
1980-81	22.74	11.4	9.9	77.26·	25.9	49.3
1984-85	19.71	10.89	8.21	80.28·	30.00	47.51
1985-86	19.40	10.00	8.76	80.60	33.23	45.19
1986-87	19.00	9.62	8.76	81.01	34.94	44.06
1987-88	17.90	9.11	8.47	82.10	36.37	43.61
1988-89	19.75	9.91	9.53	80.25	35.54	42.36
1989-90	19.22	9.16	9.69	80.78	34.93	43.39
1990-91	19.10	9.30	9.30	78.90	35.90	42.60
Sixth Plan Average 1980-81 to 1984-85	20.78	11.63	9.14	76.00	27.75	47.46
Seventh Plan Average 1985-86 to 1989-90	19.05	9.56	9.04	80.95	35.00	34.72

Source : Government of India, Ministry of Finance, Budget Documents & Indian Public Finance Statistics, Various Issues.

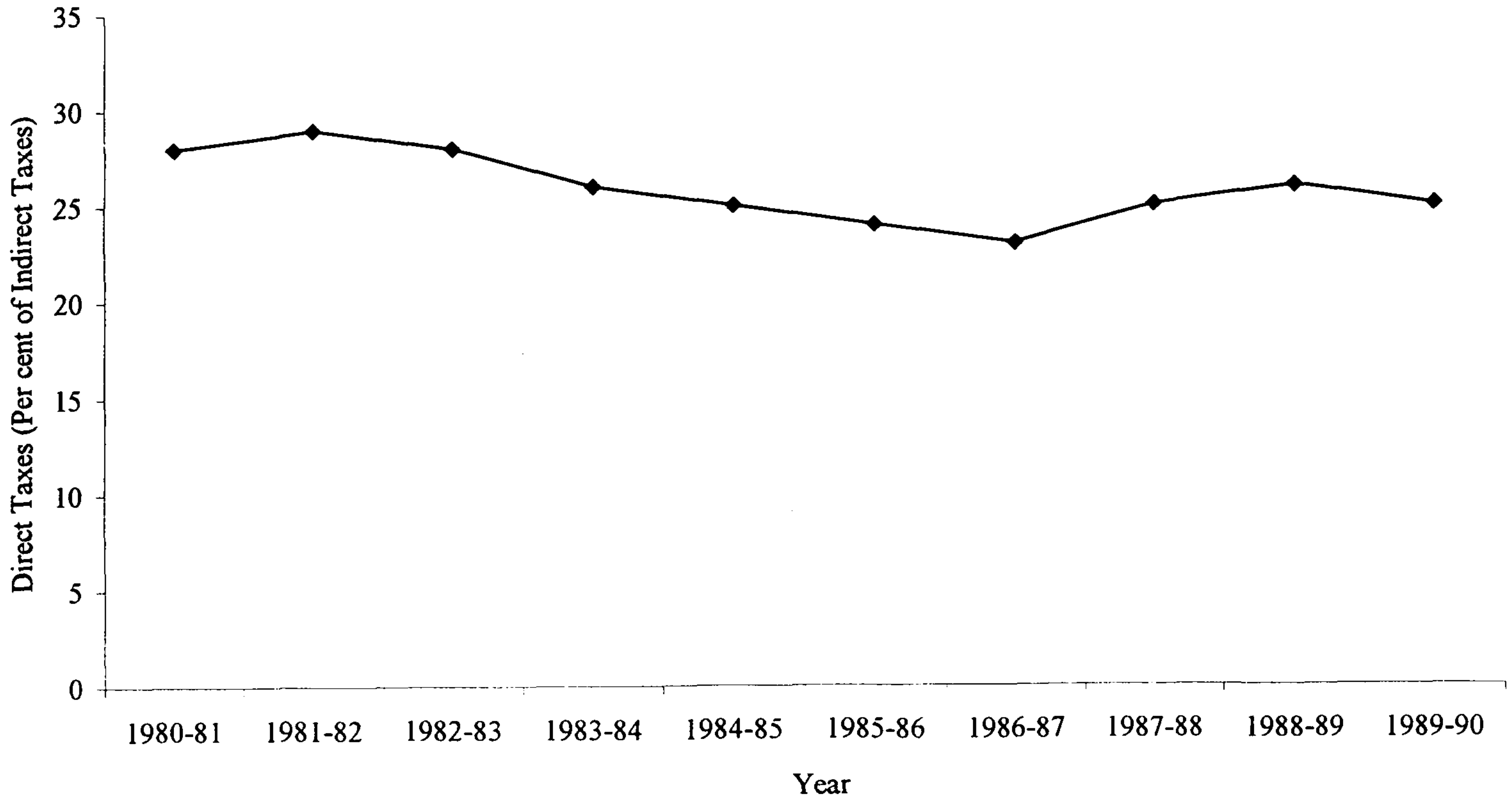
FIGURE : a-i

COMPOSITION OF TAX REVENUE OF THE CENTRAL GOVERNMENT (Per cent of Gross Tax Revenue)



Source : Government of India, Ministry of Finance, Budget Documents & Indian Public Finance statistics, Various Issues.

FIGURE : a-ii
DIRECT TAXES AS A PERCENTAGE OF INDIRECT TAXES



Source : Government of India, Ministry of Finance, Budget Documents, Various Issues.

In the realm of tax revenue, the tax to GDP ratio has moved up steadily during the decade of 1980s. From about 9.69 per cent in 1980-81 to 11.30 per cent in 1989-90 (Table A-3 & Figure a-ii). A major problem with the tax system is that the share of direct taxes has virtually stagnated during the period; it started out at 2.20 per cent of GDP in 1980-81, but after touching 2.37 in 1981-82, it had gone down to 2.06 per cent of GDP in 1990-91 (Table A-3 & Figure a-iii). During the sixth plan period the average direct tax GDP ratio was 2.23 per cent, which declined to 2.14 per cent of GDP during the seventh plan period (Table A-3 & Figure a-iii). Thus the entire increase in the tax to GDP ratio has been brought about by exploiting indirect taxes. Indirect taxes increased from 7.71 per cent of GDP during the sixth plan to 9.05 per cent of GDP during the seventh plan period. Among indirect taxes, the ratio of excise has increased from an average of 4.74 per cent of GDP to 4.89 per cent of GDP, and that of customs has increased from 2.76 per cent of GDP to 3.92 per cent of GDP during the period under reference.

As far as growth of tax revenue of the central government is concerned, it increased from 14.47 per cent during the sixth plan period to 17.11 per cent during the seventh plan period (Table A-5 & Figure a-iv). The intersting thing is that the growth rate of direct tax increased from 10.37 per cent during 1980-85 to 13.23 per cent during 1985-90, against this the growth rate of indirect tax has declined slightly; from 19.01 per cent to 18.57 per cent during the period under reference (Table A-5 & Figure a-iv).

While indirect taxes continue to be the mainstay of the tax system, there is little to suggest that there is infact any well defined rationale in

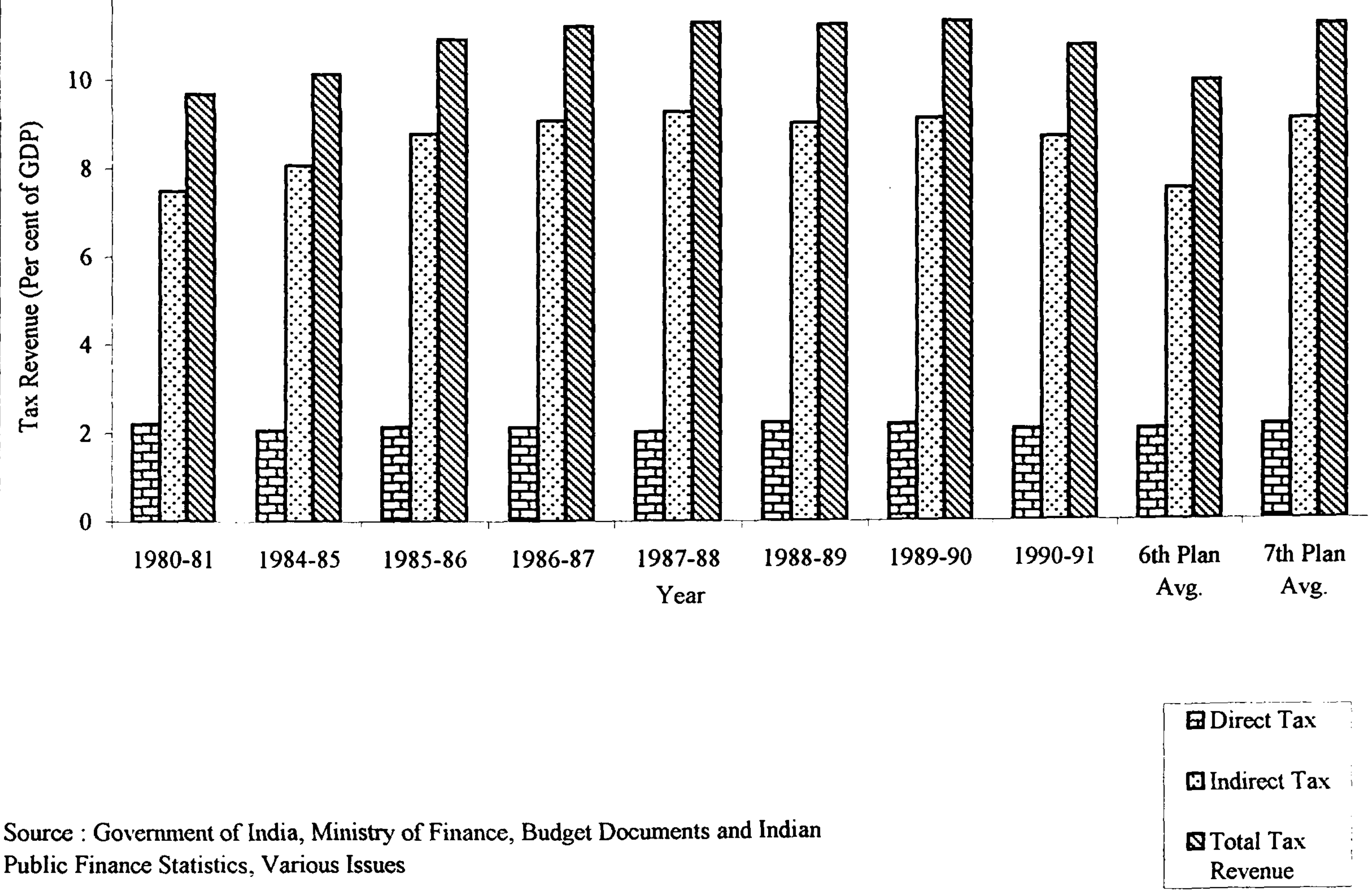
Table : A-3

TAX REVENUE OF THE CENTRAL GOVERNMENT AS PER CENT OF GDP (1980-81 to 1990-91)

	Gross			Net of States' share		
Year	**Direct Tax**	**Indirect Tax**	**Total Tax Revenue**	**Direct Tax**	**Indirect Tax**	**Total Tax Revenue**
1980-81	2.20	7.49	9.69	1.46	5.44	6.90
1984-85	2.07	8.07	10.15	1.53	6.12	7.65
1985-86	2.14	8.79	10.93	1.43	6.64	8.08
1986-87	2.13	9.08	11.21	1.39	6.93	8.32
1987-88	2.03	9.28	11.30	1.25	7.18	8.42
1988-89	2.23	9.01	11.24	1.54	7.01	8.54
1989-90	2.19	9.11	11.30	1.33	7.08	8.41
1990-91	2.06	8.69	10.75	1.29	6.75	8.04
Sixth Plan Average (1980-81 to 1984-85)	2.06	7.50	9.93	1.60	5.72	7.29
Seventh Plan Average (1985-86 to 1989-90)	2.14	9.05	11.20	1.39	6.97	8.35

Source : Government of India, Ministry of Finance, Budget Documents and Indian Public Finance Statistics, Various Issues.

FIGURE : a-iii
GROSS TAX REVENUE OF THE CENTRAL GOVERNMENT AS PERCENT TO GDP



Source : Government of India, Ministry of Finance, Budget Documents and Indian Public Finance Statistics, Various Issues

Table : A-4

DIRECT TAXES AS A PERCENTAGE OF INDIRECT TAXES (1980-81 to 1989-90)

Year	Percentage
1980-81	28
1981-82	29
1982-83	28
1983-84	26
1984-85	25
1985-86	24
1986-87	23
1987-88	25
1988-89	26
1989-90	25
Sixth Plan Average (1980-81 to 1984-85)	27
Seventh Plan Average (1985-86 to 1980-90)	25

Source : Government of India, Ministry of Finance, Budget Documents, Various Issues.

Table : A-5

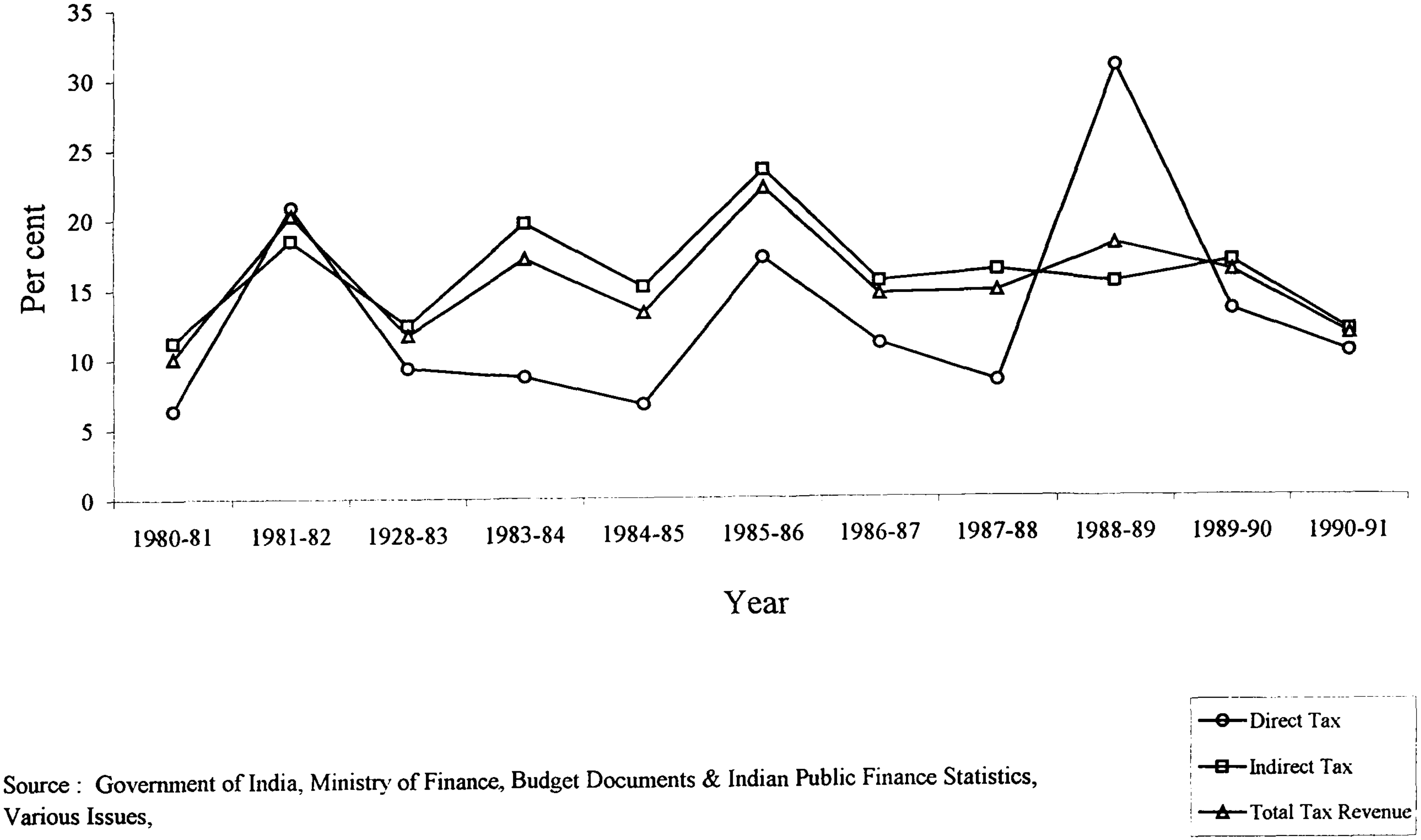
PERCENTAGE CHANGE IN THE TAX REVENUE OF THE CENTRAL GOVERNMENT (1980-81 to 1990-91)

	Gross			Net of States' share		
Year	Direct Tax	Indirect Tax	Total Tax Revenue	Direct Tax	Indirect Tax	Total Tax Revenue
1980-81	6.35	11.21	10.06	2.11	11.76	9.57
1981-82	20.84	18.45	20.24	38.78	19.12	23.27
1982-83	9.32	12.40	11.67	8.68	14.10	12.81
1983-84	8.67	19.67	17.09	10.67	20.87	18.54
1984-85	6.67	15.10	13.27	7.13	16.29	14.33
1985-86	17.13	23.45	22.15	5.89	23.16	19.70
1986-87	10.96	15.40	14.53	8.28	16.48	15.02
1987-88	8.27	16.21	14.71	2.24	17.81	15.21
1988-89	30.78	15.30	18.07	46.26	15.95	20.44
1989-90	13.28	16.80	16.10	00.02	16.58	13.60
1990-91	10.27	11.80	11.51	13.62	11.79	12.08
Sixth Plan Average (1980-81 to 1984-85)	10.37	19.01	14.47	13.47	17.10	15.70
Seventh Plan Average (1985-86 to 1990-91)	13.23	18.57	17.11	13.01	17.26	16.79

Source : Government of India, Ministry of Finance, Budget Documents and Indian Public Finance Statistics, Various Issues.

FIGURE : a - iv

PERCENTAGE CHANGE IN TAX REVENUE (Gross) OF THE CENTRAL GOVERNMENT



Source : Government of India, Ministry of Finance, Budget Documents & Indian Public Finance Statistics, Various Issues, raising revenues on this score. Almost 70 per cent of the revenue from excise duties are relaised from inputs and intermediates. There was also an incredible multiplicity in the rates of tax. Both these factors make for a lack of transparency in the incidence of these taxes and their economic effects. While a system of modified value added tax, introduced in 1986, has been instrumental in imparting a certain rationale to the excise tax system, its coverage was partial, and the overall impact of excise taxes was one of escalation of industrial costs via the cascading effect.

After analysing the tax structure and its productivity during the seventh plan period, we can say that, there is heavy reliance on indirect taxation. While the predominance of indirect taxes in the present situation is unavoidable, it cannot be said that a certain balance has to be maintained between direct and indirect taxes. Taxes like the personal income tax have an important role in the tax structure and cannot be substituted by taxes on commodities.

The lack of buoyancy in income-tax revenues is another feature, which is attributable to several factors, including narrow coverage of the working population, numerous exemptions and deductions and widespread evasion.

The indirect taxes as a whole have displayed better growth and buoyancy but among them customs have grown faster than excise. As a result, the share of customs in the taxes collected by the centre has gone up. The contribution of excise, though still the largest, has undergone a decline. The buoyancy of excise has suffered because of a variety of factors including numerous exemptions and concessions which have given rise to substantial administrative and legal complexities.

Thus, we can say that during the seventh plan period tax revenue collected by the centre was not sufficient to match the growing expenditure of a developing country like India. At that time the long-term task of the fiscal policy in the area of taxation was to bring about a structural reform in the system, which should ensure that revenues go up automatically and commensurately as incomes and prices rise.

3.2.5 Non-Tax Revenue

Non-tax revenue is an important component of the revenue receipts of Government of India and accounts for about 1/4th of the total. We may specifically note the following main features of non-tax revenue of Government of India.

* administrative receipts have always been a small proportion of the total non-tax revenue receipts.

* net contribution by public undertakings in the form of dividends has been always a marginal amount. While some undertaking do make reasonably good profit, most other incur losses only. In some cases, the accumulated losses exceed even their share capital. This is a matter of grave concern particularly because of massive investment that has gone into these undertakings.

* Salient feature of non-tax revenue of the Government of India is the steadily increasing interest receipts. The government advances sizeable

loans to state governments, public undertakings, and other parties every year and as a result the interest receipts are going up. As table A-1 shows, the proportion of interest receipts in the non-tax revenue of the central government has increased over the years barring some fluctuations, from 62.48 per cent in 1983-84 to 72.89 per cent in 1990-91.

During the seventh plan period, transport enterprises and other departmental undertakings, which have had historically low returns, have affected the performance of non-tax revenue negatively.

As it is evident in table A-1 that non-tax revenue as a proportion of total revenue receipts declined from 26.49 per cent in 1986-87 to 21.79 per cent in 1990-91. Wrong pricing policies, inefficient public enterprise operations and other difficulties have all contributed to this situation of low returns.

3.3 GROWTH OF GOVERNMENT EXPENDITURE : AN ANALYSIS OF THE TRENDS BETWEEN SIXTH AND SEVENTH PLAN PERIOD

In India, as is well known, the commanding role of the state in allocative decisions was the direct consequence of the state dominated heavy industry based import substituting development strategy. In such a framework the government had to play the roles of a catalyst as well as a direct participant in economic activity. The public expenditure policy, in particular, has had to play a crucial role in this policy of state accumulation.[7]

The economic crisis in 1990 which was triggered off by fiscal imbalances led to a reconsideration of the role of the state and brought public expenditure policy into sharper focus. Fiscal imbalances in India, which had assumed serious proportions by the mid-eighties, had two important facets. First, the outpacing of the rate of growth of revenue receipts by the expenditure growth considerably reduced the resources available for public investment in the economy. The increasing use of borrowed funds to meet current expenditures rendered the latter self propelling. Second, the increasing diversion of household savings to meet public consumption requirements not only resulted in the expansion of public debt to unsustainable levels, but also reduced the resources available for private investment'.[8] In addition to the usual allocative distortions arising from the crowding out of private sector investments, the poor performances of public sector enterprises caused further decline in productivity in the Indian economy. These fiscal developments have had adverse macro-economic repercussions as well. A portion of the excess demand generated by the expansionary fiscal policy spilled over into higher imports and consequently, aggravated the balance of payments problem.

3.3.1 Trends in Government Expenditure in India

During our reference period of a decade (1980-90), aggregate government expenditure in India showed a substantial increase. The aggregate expenditure (at current prices) of the Government of India increased by over 4.8 times from Rs. 22056 crore in 1980-81 to Rs. 105298 crore in 1990-91 (Table A-6). During this period the average annual growth rate of total expenditure of the Government of India was 17.6 per cent (Table A-8). The analysis of government expenditure growth brings out two important factors.

TABLE : A-6

EXPENDITURE OF THE CENTRAL GOVERNMENT-PLAN AND NON-PLAN (1979-80 to 1990-91)

(Rs. Crore)

	1979-80	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Total Expenditure	17787	52665	62916	68261	79111	92908	105298
A- Plan Expenditure	7189	19854	22996	24209	26151	27520	28365
I- Central Plan	4196	12791	15001	14458	16333	18049	17496
i- Economic Services	3524	10932	12809	11756	13073	14762	13859
ii- Social Services	658	1801	2134	2633	3202	3240	3597
iii- General Services	14	50	58	58	69	58	47
II- Assistance for State Plans	2782	6383	7079	8923	9082	8719	9949
III- Assistance for UT Plans	211	860	916	828	736	752	920
B- Non-Plan Expenditure	10598	32811	39920	44052	52960	65388	76933
i- Interest Payments	2210	7512	9246	11251	14278	17757	21471
ii- Defence Expenditure	3164	7988	10477	11968	13341	14416	15426
iii- Subsidies	1543	4796	5451	5980	7732	10474	12158
iv- Grants to States &UTs	624	1786	1714	1789	2186	2143	3981
v- Other Grants	58	81	114	139	124	120	139
vi- Other Non-Plan Expenditure	2215	5430	6491	7782	8386	10693	11310
vii- Non-Plan Capital Expenditure	107	382	380	667	788	1091	947
viii- Loans & Avances to States & UTs.	132	4206	3722	3134	4293	5793	7606
ix- Other Loans	545	217	1769	905	1107	2036	2881

Source : Government of India, Ministry of Finance, Budget Documents and Indian Public Finance Statistics, Various Issues.

As revenue expenditures grew faster than revenue receipts, governmental dis-savings increased considerably over time. By 1990-91, revenue deficits formed almost 3.5 per cent of GDP. Second, the rate of expenditure growth was substantially higher than the growth of non-tax revenues signifying the increasing volume of implicit subsidies in the provision of public services. The differences between cost of providing social and economic services and cost recoveries as a proportion of GDP increased during the reference period.[9]

The trends in government expenditures as percentage of GDP and as total expenditure shown in Figures a-v & vi. Both the figures clearly shows rising share of non-plan expenditure and declining share of plan expenditure. This confirms the hypothesis that governments by and large unable to control the fast growing non-plan expenditures, particularly interest payments (Table A-8 & figure a-vii). The analysis of government expenditure trends as a proportion of GDP, as a proportion of total expenditure, and growth of expenditure bring out two distinct phases. During the first phase (1980-81 to 1985-86) the expenditure - GDP ratio increased from 16.2 per cent in 1980-81 to 20.1 per cent in 1985-86, and it grew at around 20 per cent per year. In the second phase (1986-87 to 1990-91), the growth rate declined to 15.9 per cent per year. As a ratio of GDP, government expenditure remained nearly stagnant and hovered around 20 per cent during this period (Table A-7 & Figure a-v).

The two phases of expenditure growth noted above can be explained by the state of the economy. The first phase (1980-81 to 1985-86) marked

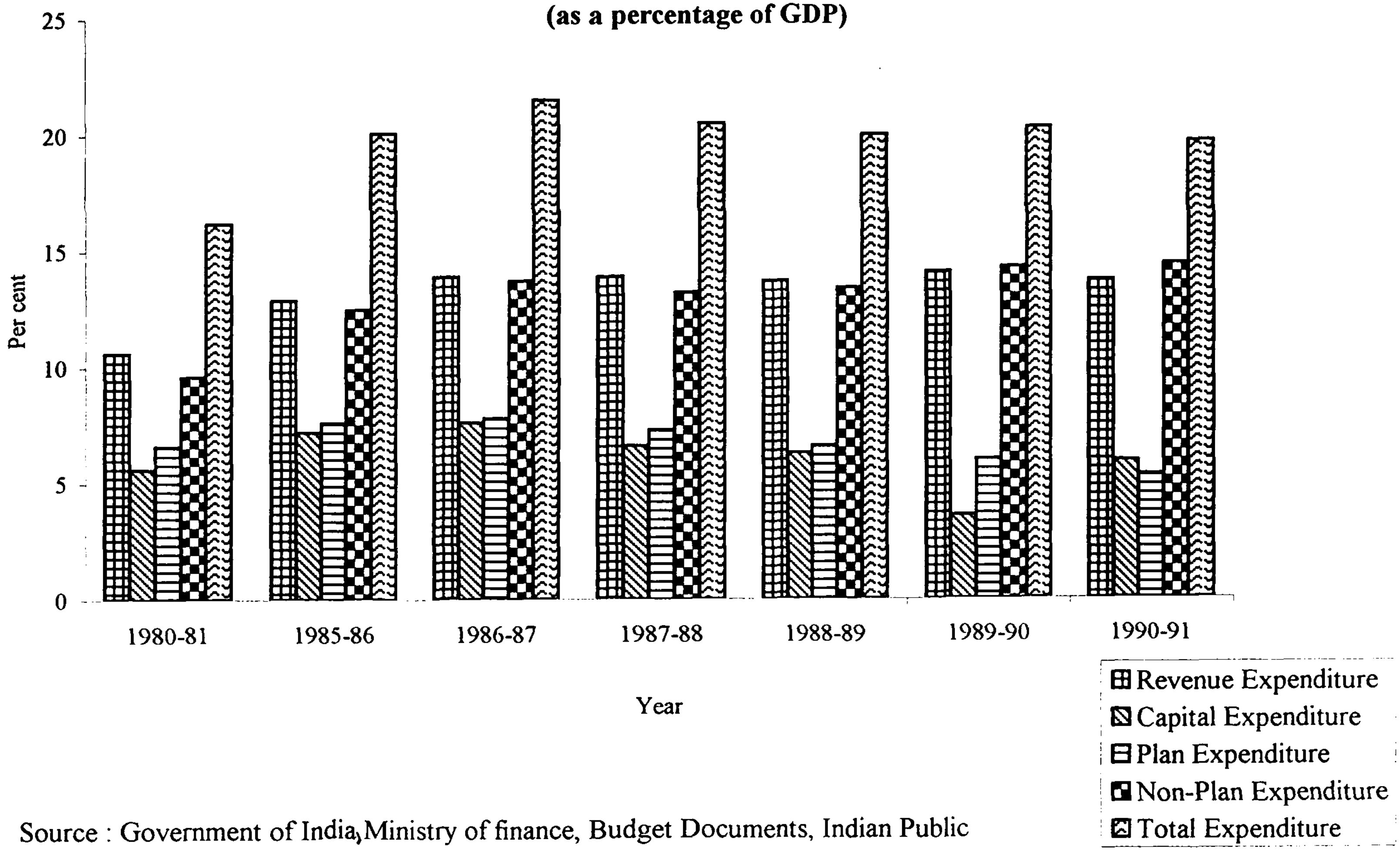
TABLE : A-7

LEVELS OF GOVERNMENT EXPENDITURE IN INDIA (1980-81 to 1990-91)

Year	Government Expenditure as a percentage of GDP					Expenditure as percentages of total Expenditure			
	Revenue Expendiure	Capital Expendiure	Plan Exp-endiure	Non-Plan Expendiure	Total Ex-pendiure	Revenue Expendiure	Capital Expendiure	Plan Exp-endiure	Non-Plan Expendiure
1980-81	10.6	5.6	6.6	9.6	16.2	65.3	34.7	40.8	59.2
1985-86	12.9	7.2	7.6	12.5	20.1	64.4	35.6	37.7	62.3
1986-87	13.9	7.6	7.8	13.7	21.5	64.9	35.1	36.5	63.5
1987-88	13.9	6.6	7.3	13.2	20.5	67.6	32.4	35.5	64.5
1988-98	13.7	6.3	6.6	13.4	20.0	68.4	31.6	33.1	66.9
1989-90	14.1	6.3	6.0	14.3	20.3	69.1	30.9	29.6	70.4
1990-91	13.7	5.9	5.3	14.4	19.7	69.8	30.2	26.9	73.1

Source : Government of India, Ministry of Finance, Union Budget Documents and Indian Public Finance Statistics, Various Issues.

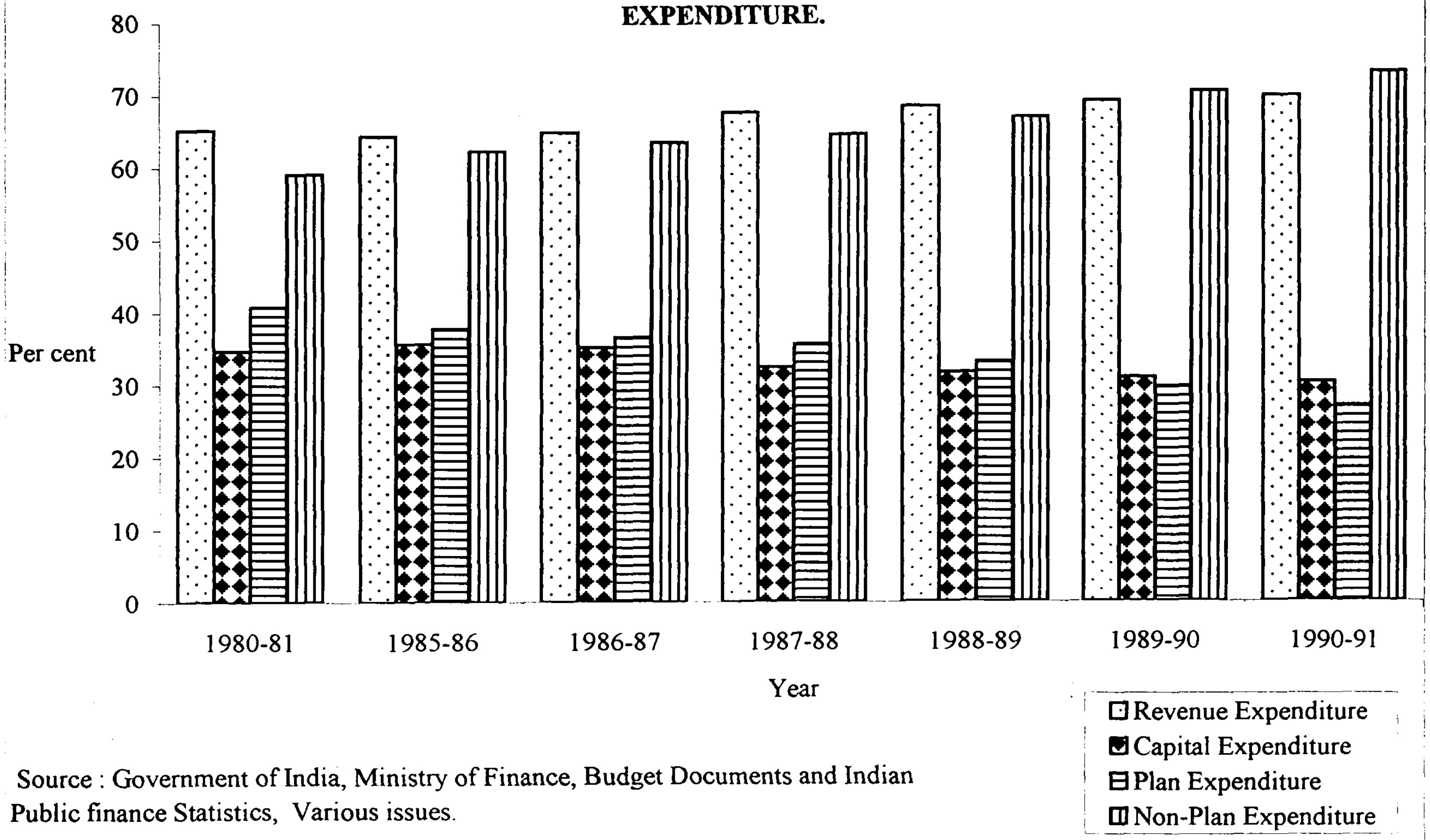
FIGURE : a - v
EXPENDITURE OF THE CENTRAL GOVERNMENT
(as a percentage of GDP)



Source : Government of India, Ministry of finance, Budget Documents, Indian Public Finance Statistics, Various Issues.

FIGURE : a - vi

VARIOUS EXPENDITURES OF THE CENTRAL GOVERNMENT AS SHARES OF TOTAL EXPENDITURE.



Source : Government of India, Ministry of Finance, Budget Documents and Indian Public finance Statistics, Various issues.

by a significant fluctuation (but overall acceleration) in the rate of growth of expenditures. During the period, the government revenues increased at considerably higher rates. The reform of the tax system and the replacement of physical restrictions on imports with tariffs mainly contributed to revenue buoyancy. Given the relatively stable political environment and buoyant revenues in the first phase, the growth of government expenditures showed a significant acceleration with fluctuation. This was further fuelled by the emergence of significant revenue deficits since 1982-83 and their feedback in terms of increased interest payments. This phase can be easily characterized as the period of fiscal expansion.

In the second phase, the share of expenditure in GDP actually showed a marginal decline. This analysis bring out an interesting feature, that is, the steep growth of non-plan expenditure both as a ratio of GDP and as a percentage of total expenditure. During the second phase when on the one hand, expenditure as a ratio of GDP marginally declines and overall growth of expenditure also declined, on the other hand non plan expenditure grew rapidly in both terms, as a proportion of GDP and as a share of total expenditure (Table A-7 & Figure a-v & a-vi).

Interestingly, a major part of the increase in government expenditure share in GDP in the 1980s was due to the phenomenal expansion in revenue expenditures (Table A-7). However, capital expenditures showed a decline. As a proportion of GDP, capital expenditures declined from 7.2 per cent in 1985-86 to 5.9 per cent in 1990-91. Consequently, capital expenditures which constituted about 35.6 per cent of total expenditure in

TABLE : A-8

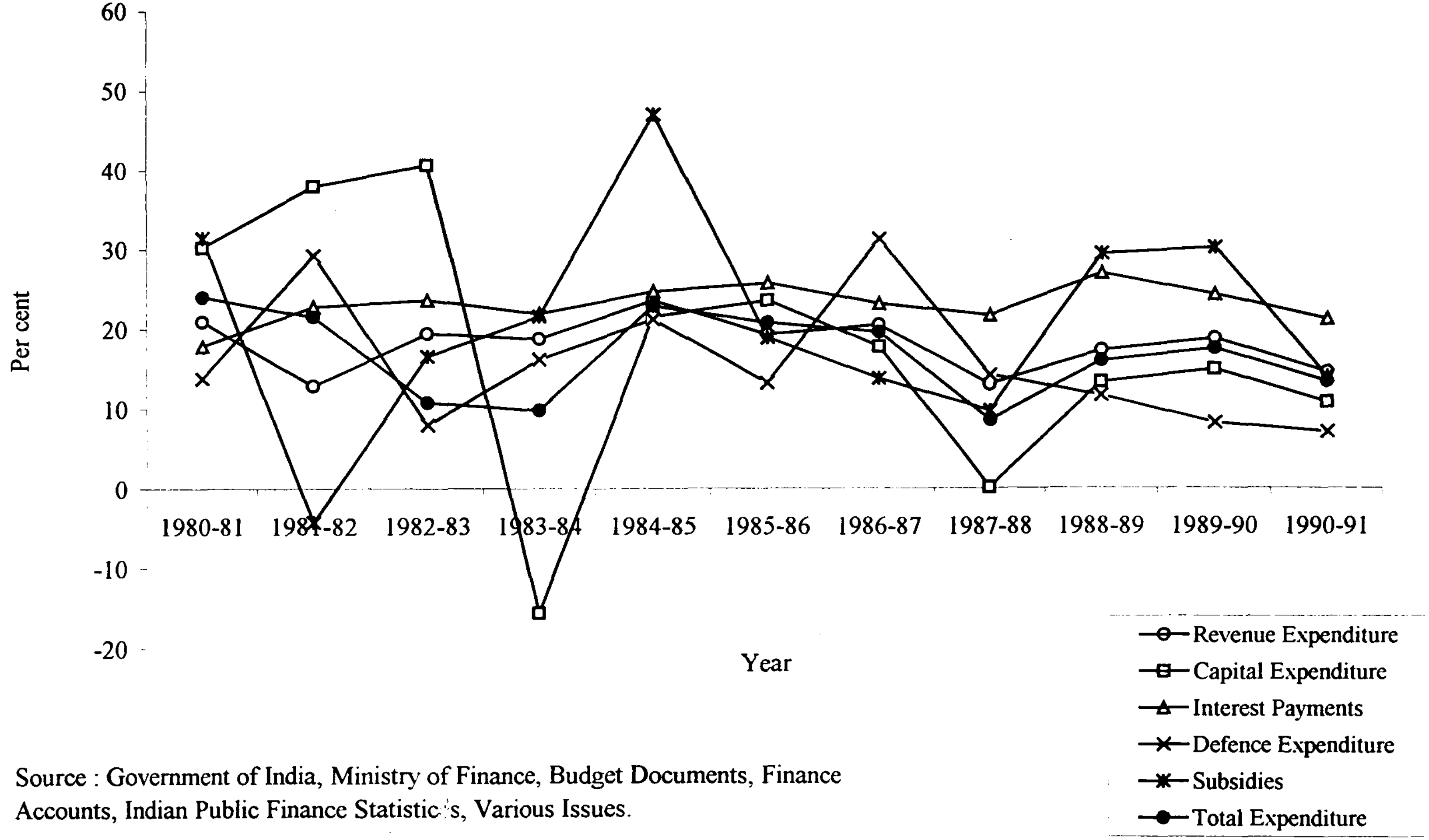
PERCENTAGE CHANGE IN THE EXPENDITURES OF THE CENTRAL GOVERNMENT (1980-81 to 1990-91)

Year	Revenue Expendiure	Capital Expendiure	Interest Payments	Defence	Subsidies	Plan Expen-diture	Non-Plan Expenditure	Total Expenditure
1980-81	20.9	30.2	17.8	13.8	31.4	25.1	23.2	24.0
1981-82	12.8	34.9	22.7	29.2	-4.3	17.1	23.3	21.5
1982-83	19.4	40.6	23.6	7.9	16.5	11.3	10.4	10.7
1983-84	18.7	-15.7	21.8	16.1	21.5	17.8	20.9	19.7
1984-85	23.5	21.5	24.6	21.1	46.9	18.3	25.7	22.8
1985-86	19.2	23.5	25.7	13.1	18.8	19.6	21.4	20.7
1986-87	20.4	17.7	23.1	31.2	13.7	15.8	21.7	19.5
1987-88	13.0	0.14	21.7	14.2	9.7	5.3	10.4	8.5
1988-89	17.2	13.2	26.9	11.5	29.3	8.0	20.2	15.9
1989-90	18.7	14.8	24.2	8.1	30.1	8.6	21.8	17.4
1990-91	14.5	10.7	21.1	7.0	13.9	3.1	17.7	13.3
1980-81 to 1984-85 (Avg.)	19.1	22.9	22.1	17.6	22.4	17.9	20.7	19.7
1985-86 to 1990-91 (Avg.)	17.2	13.3	23.8	14.2	19.3	10.1	18.9	15.9
1980-81 to 1990-91 (Avg.)	18.1	17.7	23.0	15.7	20.7	13.6	19.7	17.6

Source : Government of India, Ministry of Finance, Union Budget Documents, Finance Accounts and Indian Public Finance Statistics, Various Issues.

FIGURE : a - vii

PERCENTAGE CHANGE IN THE EXPENDITURES OF THE CENTRAL GOVERNMENT



Source : Government of India, Ministry of Finance, Budget Documents, Finance Accounts, Indian Public Finance Statistics, Various Issues.

1985-86 declined to about 30 per cent by 1990-91 (Table A-7 & Figures a-v and a-vi).

The largest increase in the share of revenue expenditures over the period came about on account of increase in interest payments. The expenditure on interest payments as a proportion of GDP increased from 2.3 per cent in 1981-82 to 4.7 per cent in 1990-91, and as a proportion of total expenditure, it increased from 9.6 per cent to 16.4 per cent during the same period (Table A-11). The increase in interest payment was particularly marked in the eighties. This was due to increase in both the volume of indebtedness of the government and in the aggregate effective rate of interest on govenrment borrowings. Table A-9 shows that the outstanding debt of centre and states together as a proportion of the GDP rose almost continuously from 49 per cent in 1979-80 to 65.7 per cent in 1990-91. It may be noted that the proportion of external debt actually fell from 8.7 per cent to 5.9 per cent of GDP during this period, and the rise in indebtedness is entirely attributable to the rise in internal debt and other liabilities of the government. Table A-10 shows that the average effective rate of interest on government borrowing in India has risen substantially from 4.4 per cent in 1980-81 to 7.2 per cent in 1990-91. An important reason for this trend has been a shift in the composition of outstanding debt in favour of more costly ones.

An important source of government expenditure growth was significant increase in the emoluments of government employees. The central and state government employees formed just about 1.2 per cent of population in 1989-90, but the share of wages and salaries received by them constituted 6.3 per cent of GDP.[10]

TABLE A-9

OUTSTANDING DEBT OF THE CENTRAL AND STATE GOVERNMENTS (As Percentage of GDP)

	1979-80	1984-85	1989-90	1990-91
A- Centre	43.9	49.0	59.1	59.3
1- Internal debt	21.3	25.3	29.3	29.0
2- External debt	8.7	7.2	6.2	5.9
3- Other liabilities of which	13.9	16.5	23.5	24.3
a -Small Savings	6.0	7.4	9.2	9.4
b -Provident Fund	2.1	1.8	2.1	2.2
B- States*	5.2	5.8	6.4	6.5
C- Total	49.1	54.9	65.4	65.7

* Excludes Loans from the Central Government.

Source: 1. R.B.I., Report on Currency & Finance, Various Issues.

2. Govenrnment of India, Ministry of Finance, Indian Public Finance Statistics, Various Issues.

TABLE : A-10

COST OF GOVERNMENT BORROWING IN INDIA (1980-81 to 1990-91)

Year	Interest Payments (Rs. Crore)	Amount of Outstanding Debt at end-March (Rs. Crore)	Effective Rate of Interest
1980-81	2957	66655	4.4
1981-82	3745	76835	4.9
1982-83	4637	93837	4.9
1983-84	5524	105767	5.2
1984-85	6863	126919	5.4
1985-86	8606	152053	5.7
1986-87	10591	183422	5.8
1987-88	12991	215121	6.0
1988-89	16447	253309	6.5
1989-90	20501	297125	6.9
1990-91	25006	348909	7.2

Source : 1 RBI, Report on Currency & Finance, Various Issues.

2 Government of India, Ministry of Finance, Indian Public Finance Statistics, Various Issues.

The steep rise in wages and salaries was not the only source of high growth of current expenditure even during the period of fiscal restraint. Expenditure on subsidies increased at an average annual rate of 21 per cent during 1980-81 to 1990-91. The increase in subsidies was mainly under food, fertiliser and irrigation heads which it is believed accrue largely to the rich farmers.[11]

3.3.2 Expenditure Trends by Functional Categories

i. Administrative Services

Expenditure on administrative services as proportion of GDP and as a proportion of total expenditure increased from 5.4 per cent and 22.0 per cent respectively in 1981-82 to 6.9 per cent and 22.7 per cent in 1986-87. However, the growth rate decelerated thereafter and their share declined to 6.2 per cent of GDP and 21.7 per cent of total expenditure in 1990-91 (Table A-11 & Figure a-viii). An interesting point to be noted relates to the trends observed with regard to expenditures on defence. While the growth of revenue expenditures under defence has been relatively small for the whole period in reference, capital expenditures have shot up in the eighties.

ii. Social and community services

Expenditures on social services formed 6.4 per cent of GDP and about 22.5 per cent of total expenditures in 1990-91 (Table A-11 & Figure a-ix). As these services are employment-intensive, wage cost predominated and almost 94 per cent of the expenditure on these items was of current nature. As was seen in the case of aggregate expenditures, the growth of expenditure on social and community services showed a noticeable increase

TABLE : A-11

GOVERNMENT EXPENDITURE BY FUNCTIONAL CATEGORIES : LEVEL AND COMPOSITION

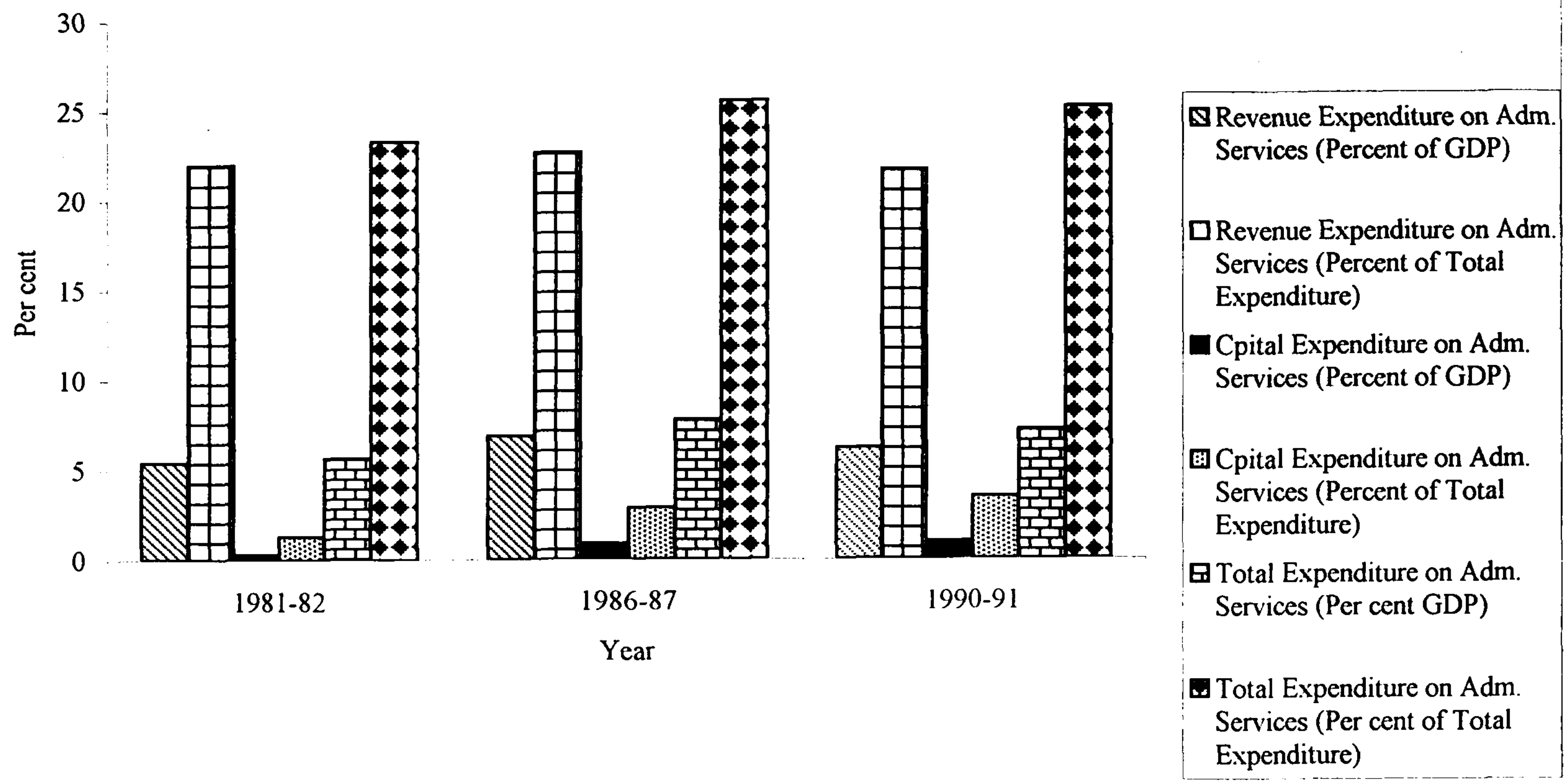
Period	Interest payments as percentage of		Administrative Services as percentage of		Social & Community services as percentage of		Economice Services as percentage of		Net Loans and Advances as percentage of		Total Expenditure as percentage of	
	GDP	Total	GDP	Total	GDP	Total	GDP	Total	GDP	Total	GDP	Total
Revenue Expenditure												
1981-82	2.3	9.6	5.4	22.0	5.0	20.5	4.3	18.0	-	-	17.1	69.9
1986-87	3.6	11.9	6.9	22.7	6.2	20.2	5.6	18.4	-	-	22.3	73.0
1990-91	4.7	16.4	6.2	21.7	6.1	21.3	5.8	20.5	-	-	23.8	79.7
Capital Expenditure												
1981-82	-	-	0.3	1.3	0.4	1.6	4.3	17.5	2.4	9.8	7.4	30.1
1986-87	-	-	0.9	2.9	0.6	2.0	4.2	13.8	2.6	8.4	8.2	27.0
1990-91	-	-	1.0	3.5	0.4	1.2	2.9	9.9	1.6	5.5	5.8	20.3
Total Expenditure												
1981-82	2.3	9.6	5.7	23.3	5.4	22.0	8.6	35.5	2.4	9.8	24.5	100.0
1986-87	3.6	11.9	7.8	25.6	6.8	22.1	9.8	32.2	2.6	8.4	30.5	100.0
1990-91	4.7	16.4	7.2	25.2	6.4	22.5	8.7	30.4	1.6	5.5	29.6	100.0

Source : Government of India, Ministry of Finance, Indian Public Finance Statistics, Various Issues.

FIGURE : a - viii

EXPENDITURE OF THE CENTRAL GOVERNMENT ON ADMINISTRATIVE SERVICES

(Per cent of GDP and Total Expenditure)



Sources : Government of India, Ministry of Finance, Indian Public Finance Statistics, Various Issues.

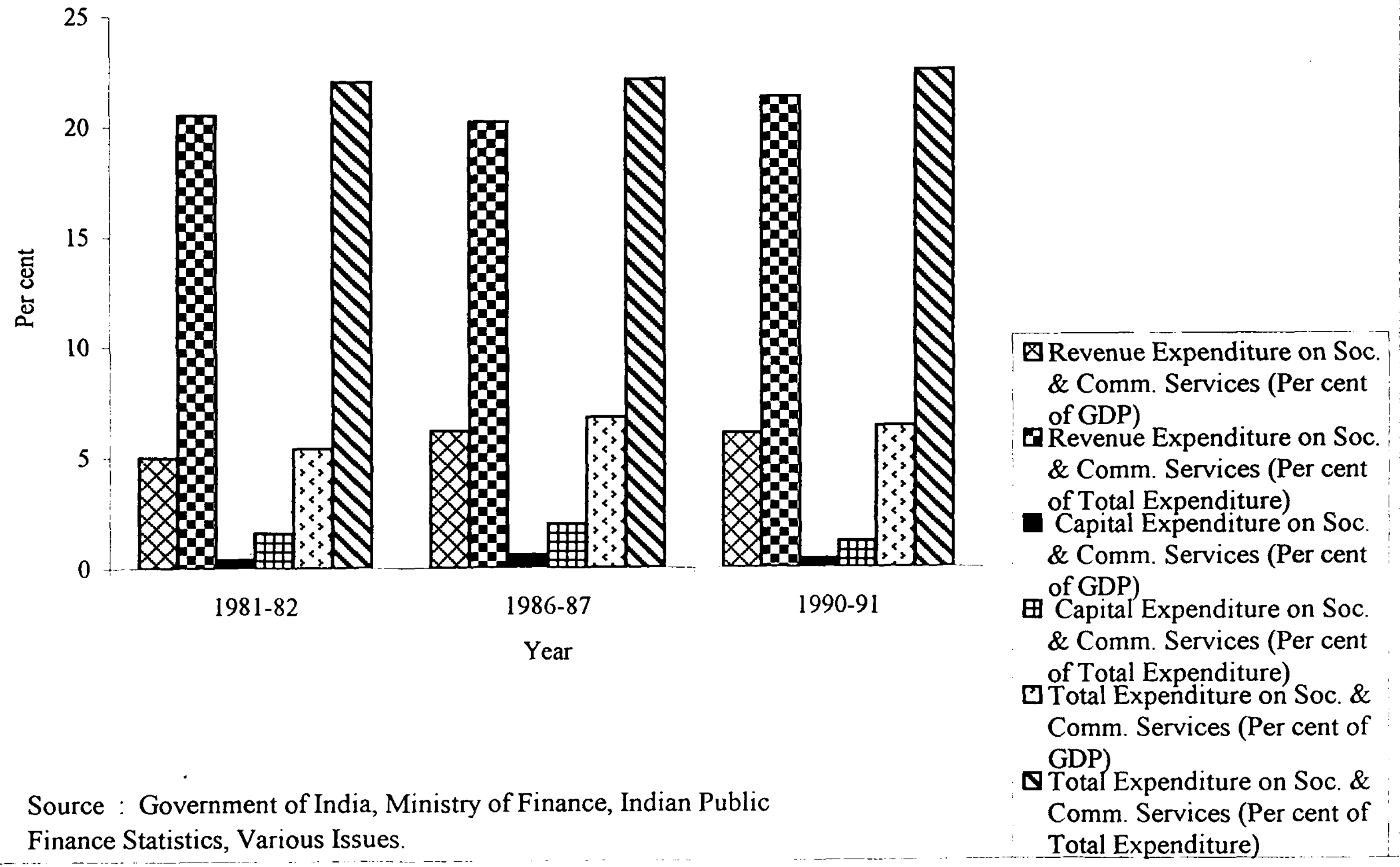
during the first phase (1981-82 to 1986-87) and thereafter declined marginally. As a proportion of GDP, after a steady increase from 5.4 per cent in 1981-82 to 6.8 per cent in 1986-87, expenditure on these services marginally declined to 6.4 per cent in 1990-91 (Table A-11 and figure a-ix).

The growth rate of expenditure in social services accelerated significantly during the first phase, but declined thereafter. This is attributable mainly to the trends in capital expenditure. On the contrary, revenue expenditure, overwhelmingly wages and salaries, accelerated in the first phase and continued to grow at a high rate even during the second period.

iii. Economic Services

Expenditure on economic services formed about one third of total expenditure and this share marginally declined during the referred period. As a proportion of GDP, the expenditure on economic services increased appreciably in the first phase and declined thereafter. The expenditure GDP ratio increased from 8.6 per cent in 1981-82 to 9.8 per cent in 1986-87. It subsequently declined to 8.7 per cent in 1990-91 (Table A-11 & Figure a-x). The decline was mainly due to cutbacks in capital expenditure. The trend in expenditure on economic services differed from the trends in other categories, the growth rate of expenditure on economic services showed a continuous decline throughout the period. The analysis of government expenditures on economic services reveals that major sources of high growth of current expenditures on economic services were subsidies and other transfers. The share of these items in total expenditure on economic services showed a continuous increase.

FIGURE : a - ix
EXPENDITURE OF THE CENTRAL GOVERNMENT ON SOCIAL & COMMUNITY SERVICES (Per cent of GDP and Total Expenditure)

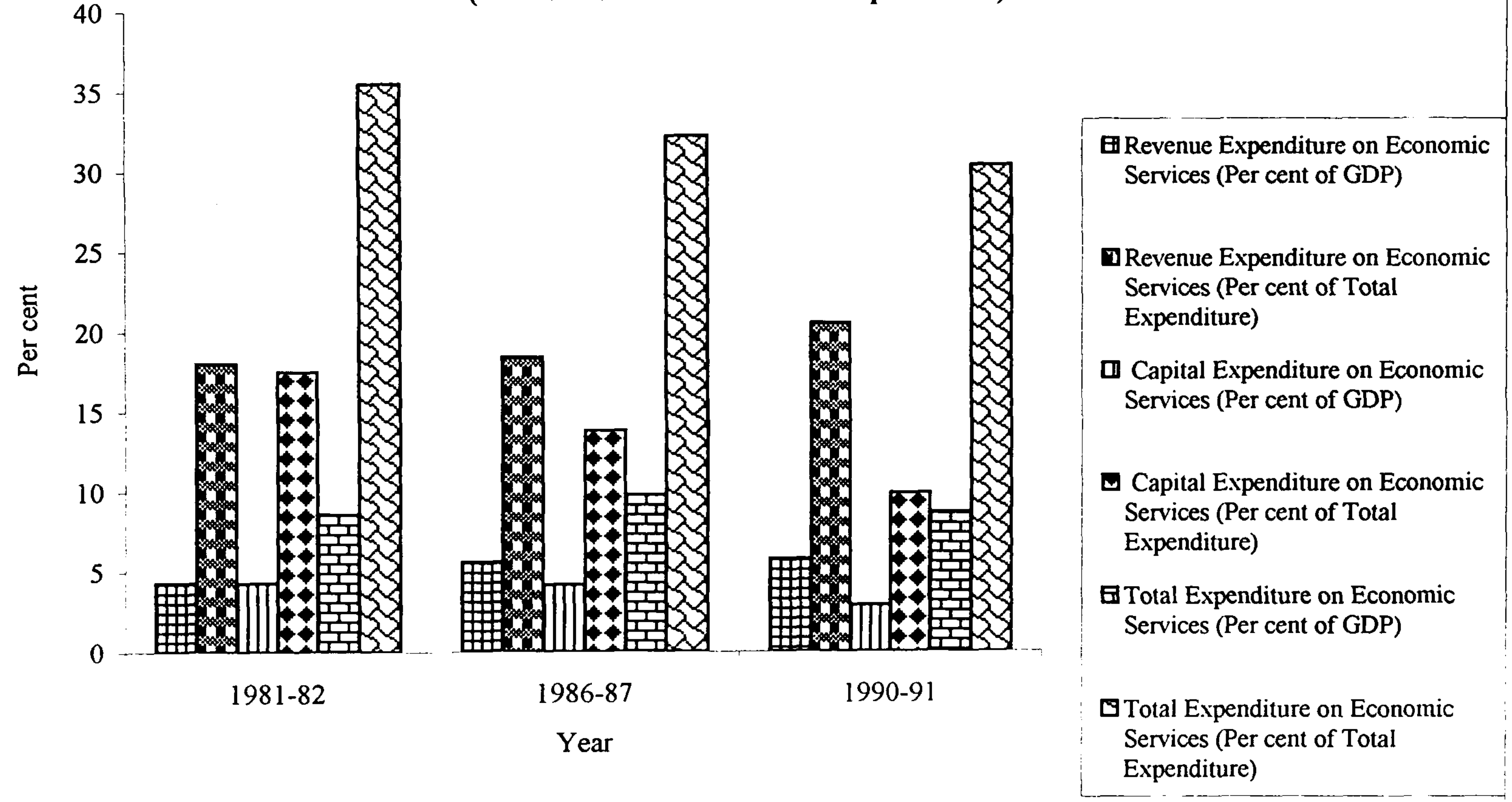


Source : Government of India, Ministry of Finance, Indian Public Finance Statistics, Various Issues.

FIGURE : a-x

GOVERNMENT EXPENDITURE ON ECONOMIC SERVICES

(Per cent of GDP and Total Expenditure)



Source : Government of India, Ministry of Finance, Indian Public Finance Statistics, Various Issues.

The analysis of government expenditure trends since early eighties and particularly during the seventh plan highlights the sharp increases on expenditures on quasi-public goods, subsidies, transfer payments and interest payments. This sharp rise of expenditures on these items points towards the inevitability of a fiscal crisis. The analysis also points towards the difficulty in achieving fiscal equilibrium in the short and medium term context until expenditures on these items remain large and rising. In other words, we can say that the overall trends in government expenditures clearly indicate towards an inevitable fiscal crisis.

3.4 PROBLEM OF FISCAL STABILIZATION AND PUBLIC SECTOR ENTERPRISES

The public sector was originally conceived as holding the commanding heights of the economy and leading technological advance. It was also intended to generate investible surpluses and become an engine for self-reliant growth. The public sector has contributed significantly to the diversification of India's industrial structure. But its contribution in terms of generating internal resources for further expansion has fallen short of expectations, and its inability to do so contributed in the worsening of the fiscal situation during the entire seventh plan period.

In the present context, inability of public sector enterprises to generate a reasonable rate of return on capital invested is widely perceived as an important cause for the serious and growing fiscal imbalance in the eighties. Commenting on the poor financial performance of public sector enterprises, Bimal Jalan said :

"..... as far as public enterprises are concerned, the after-tax profit of central government commercial enterprises as a ratio of capital employed was 4.5 per cent in 1989-90. The performance of state level PSEs has been even worse. These enterprises had net losses of Rs. 1928 crores in 1990".[12]

Vaidyanathan identifies their unsatisfactory resource generation record as an important failure of planning in India :

"Subsidies, both implicit and explicit, are also part of reason for low return to investment in public enterprises. The inability of public enterprises to generate surpluses for reinvestment and to become a progressively more important source of both aggregate savings and finances for public investment has been a major failure of our planning".[13]

While there could be considerable merit in these arguments, it is perhaps important to assess empirically, whether such a trend can be considered an important, cause for the growing fiscal imbalance in the eighties.

3.4.1 Performance of Central Government's Public Sector Enterprises

There were 246 central government public enterprises as on March 31, 1991, out of which 236 enterprises were in operation. Net profits of these enterprises declined from Rs. 3789 crore in 1989-90 to Rs. 2368 crore in 1990-91 (Table A-12). The rate of return, as measured by the ratio of net profits to capital employed, declined from 4.5 per cent in 1989-90 to 2.3 per cent in 1990-91, the lowest since 1984-85. As in the previous years, the petroleum sector accounted for the bulk of the net profit, Rs. 2299 crore out of the total of Rs. 2368 crore. However, there was a decline in the net profits

TABLE : A-12

PROFILE OF CENTRAL GOVERNMENT'S PUBLIC SECTOR ENTERPRISES (1980-81 to 1990-91)

		1980-81	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Noumber. of Running Public Enterprises	Number	163	207	211	214	221	226	233	236
Capital Employed	Rs. Crore	18207	36382	42965	51835	55554	67629	84869	101747
Turnover	Rs. Crore	28635	54784	62360	69088	81271	93137	106069	118355
Gross Margin (Profit before Depreciation, Interest & Tax)	Rs. Crore	2401	7386	8230	9897	11134	13438	16412	18510
Depreciation*	Rs. Crore	983	2758	2983	3376	4150	4866	5790	7151
Gross Profit before Interest and Tax	Rs. Crore	1418	4628	5287	6521	6984	8572	10622	11359
Interest	Rs. Crore	1399	2529	3115	3420	3595	4167	5329	7539
Net Profit before Tax	Rs. Crore	19	2099	2172	3101	3389	4405	5293	3820
Tax	Rs. Crore	222	1190	1000	1330	1329	1411	1504	1452
Net Profit after Tax	Rs. Crore	-203	909	1172	1771	2060	2994	3789	2368
Internal Resources Generated (Gross)	Rs. Crore	1225	4251	5068	6014	6947	8915	10774	11372
Net Profit (after tax) to Capital Employed	Per cent	-1.1	2.5	2.7	3.4	3.7	4.4	4.5	2.3

* Includes deferred revenue expenditure.

Source : Government of India, Ministry of Finance, Economic Survey, Various Issues.

of both petroleum and non-petroleum sectors. The fall in the net profit during 1990-91 is marked in the case of Oil and Natural Gas Commission, Bharat Cooking Coal Ltd., Export Credit Guarantee Corporation and Mahanagar Telephone Nigam Ltd., Rashtriya Ispat Nigam Ltd. had incurred a net loss of Rs. 478 crore in 1990-91, the very first year of its operation. National Thermal Power Corporation (NTPC) and Indian Railway Finance Corporation had improved their net profits by Rs. 164 crore and Rs. 98 crore respectively in 1990-91. During the year 1990-91, 146 central public enterprises generated gross internal resources to the extent of Rs. 11372 crore (Table A-12).

The working results of departmentally run commercial undertakings of states and union territories have continued to be poor of all departmentally run enterprises, only forest and mines have been generating net surpluses. While the profits from forest and mines registered a modest increase between 1985-86 and 1991-92, non-profit making enterprises registered losses more than double during the period. The unsustainable nature of the operations of these enterprises is mainly attributable to uneconomic pricing. The two major non-departmental undertakings, viz., the State Electricity Boards and the State Road Transport Corporations continued to incur substantial losses in their operations. The overall losses of all SEBs taken together amounted to Rs. 4104 crore in 1989-90 and Rs. 4169 crore in 1990-91. The performance in terms of rate of return on capital (after depreciation and interest) was negative, being -16.4 per cent in 1989-90 and -13.8 per cent in 1990-91. An important factor contributing to the high level of commercial losses of SEBs is the requirement to supply electricity to the rural agricultural sector at lower tariff'.[14]

3.4.2 Financing of Public Expenditure and Investment

How have the increasing public expenditure and investment been financed ? Total taxes (direct plus indirect taxes minus subsidies) as a proportion of the sum of government final consumption expenditure and public sector gross domestic capital formation at current prices has increased since 1984-85. Contribution of gross saving of public sector declined steadily since mid seventies. Therefore, an increasingly large share of public sector expenditure and investment is being financed by borrowing. However, it is interesting to discover that while the share of public sector as a whole in financing of public expenditure and investment has declined, the contribution of non-departmental enterprises has, infact, steadily increased since 1980-81. Correspondingly, the share of saving of administrative departments declined sharply since 1981-82 and turning negative since 1984-85. The foregoing evidence seems to suggest that the problem of declining saving rate of public sector as a whole is on account of the growing expenditure and subsidies of administrative departments relative to their revenue receipts.

After the above analysis we can say that public sector enterprises contributed very much to the problem of fiscal stabilization. In 1990-91, when there was a severe fiscal crisis in the economy, public sector enterprises have played very important role in the inception of that crisis.

3.5 EMERGENCE OF FISCAL IMBALANCE

The fiscal crisis in 1990 was not a coincidence. The fiscal situation had deteriorated throughout the 1980s due to growing burden of non-plan expenditure and non-performance of public sector enterprises. Throughout the eighties, all the major indicators of fiscal imbalance reflected that it was on the rise. The indicators which are often considered to assess the fiscal imbalance are the conventional budgetary deficit, the revenue deficit, the gross fiscal deficit and the primary deficit. The budgetary deficit denotes the difference between all receipts and expenditure, both revenue and capital. The revenue deficit refers to the difference between revenue receipts and revenue expenditure. The budgetary deficit and the revenue deficit are known as the conventional measures of fiscal imbalance. They do not completely reflect the structural imbalance in the fiscal operations of the government and can not be considered as appropriate measures of the resource gap. They indicate only a part of the gap which is mainly financed by the issue of treasury bills. A large portion of the gap in resources is financed by market borrowings, small savings, provident funds, external borrowings etc. and this does not get reflected in the conventional indicators of fiscal imbalance. In contrast, the concept of fiscal deficit is a more complete measure of fiscal imbalance. The fiscal deficit reflects the total resource gap which equals the excess of total government expenditure over government revenue and grants. The fiscal deficit thus fully indicates the indebtedness of the government. The primary deficit is the fiscal deficit less interest payments.[14]

The trends in vairous indicators of fiscal imbalance since 1980-81 are given in Table A-13 and diagramatically shown in Figure a-xi, from the

TABLE : A-13

VARIOUS MEASURES OF DEFICIT IN THE CENTRAL GOVERNMENT'S BUDGET (as Per cent of GDP)

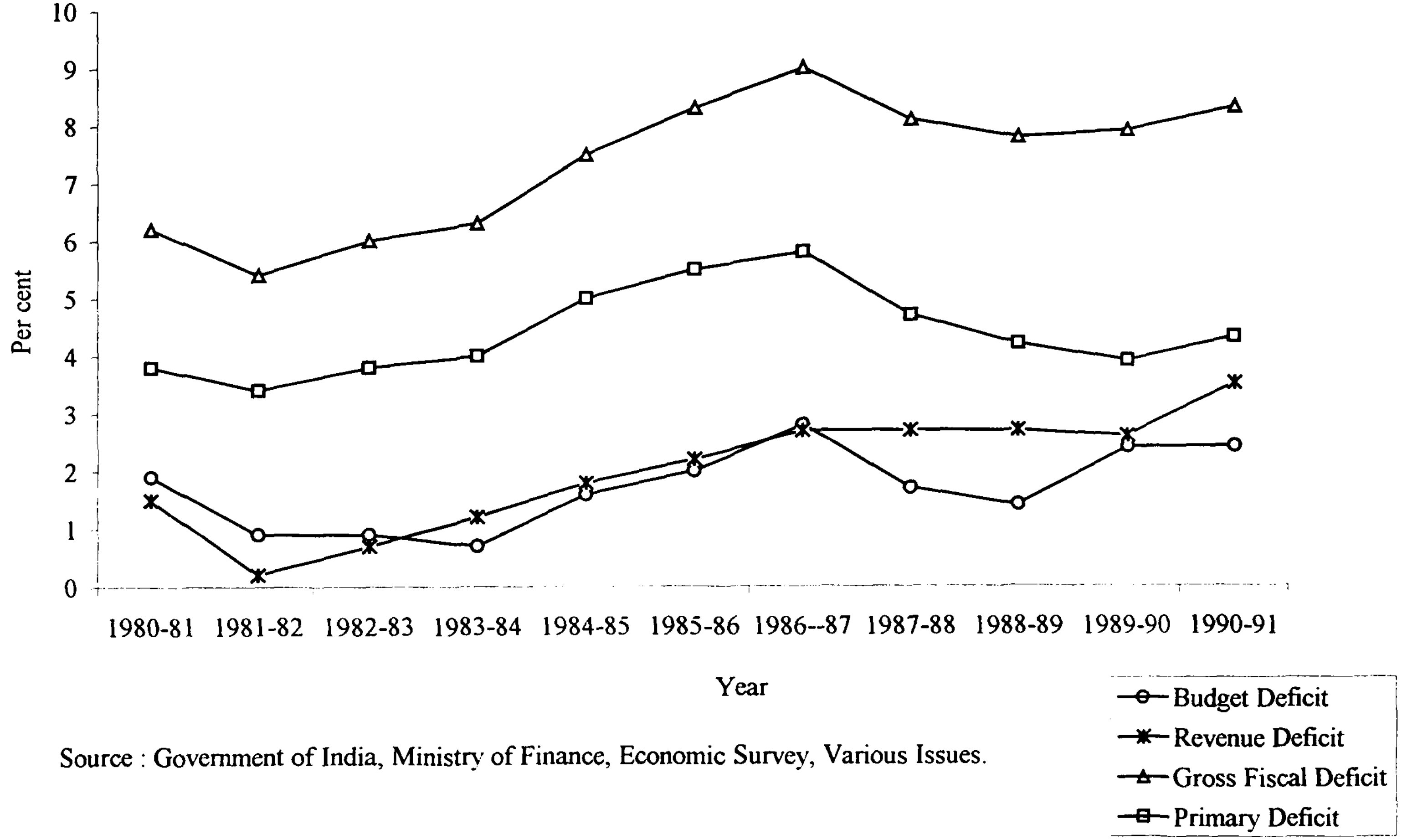
Year	Budget Deficit	Revenue Deficit	Gross Fiscal Deficit	Primary Deficit
1980-81	1.9	1.5	6.2	3.8
1981-82	0.9	0.2	5.4	3.4
1982-83	0.9	0.7	6.0	3.8
1983-84	0.7	1.2	6.3	4.0
1984-85	1.6	1.8	7.5	5.0
1985-86	2.0	2.2	8.3	5.5
1986-87	2.8	2.7	9.0	5.8
1987-88	1.7	2.7	8.1	4.7
1988-89	1.4	2.7	7.8	4.2
1989-90	2.4	2.6	7.9	3.9
1990-91	2.4	3.5	8.3	4.3
Sixth Plan Average (1980-81 to 1984-85)	1.2	1.1	6.3	4.1
Seventh Plan Average (1985-86 to 1989-90)	2.1	2.6	8.2	4.8

Source : Government of India, Ministry of Finance, Economic Survey, Various Issues.

FIGURE : a - xi

VARIOUS MEASURES OF DEFICIT IN THE CENTRAL BUDGET

(as Per cent of GDP)



Source : Government of India, Ministry of Finance, Economic Survey, Various Issues.

Table A-13 and the Figure a-xi it is evident that between 1980-81 and 1990-91 the two conventional indicators of fiscal imbalance have risen substantially. The budgetary deficit increased from 1.9 per cent in 1980-81 to 2.4 per cent of GDP in 1990-91. The revenue deficit rose from 1.5 per cent in 1980-81 to 3.5 per cent of GDP in 1990-91. These facts suggest that the fiscal situation had been under mounting pressure throughout the eighties. In this period the gross fiscal deficit rose alarmingly from 6.2 per cent in 1980-81 to 8.3 per cent of GDP in 1990-91. Similarly primary deficit which was 3.8 per cent of GDP in 1980-81 rose to 4.3 per cent of GDP in 1990-91.

Interest payments on accumulated debts constituted about 28 per cent of the total revenue expenditure of the central government. In fact, in 1990-91 interest payments had eaten up 36.6 per cent of the total revenue collections of the central government. The fiscal crisis of 1990-91 had been mainly caused by unchecked growth of non-plan revenue expenditure, particularly on defence, interest payments and food and fertiliser subsidies during the eighties. This was obviously the outcome of indiscreet policy measures and indulgence in populism at the government level.

3.5.1 Deepening of the Fiscal Crisis

On the whole it is widely agreed that the Indian economy had faced a severe economic crisis. The crisis was possibly the severest in the post-independence era. The fiscal sector of the economy was possibly in the throes of its most stringent test ever. The foreign trade sector of the economy had been in great trouble.

In the fiscal sector, government expenditure had been outpacing revenues for more than a decade, leading the government to resort to substantial borrowings. The national debt reached such a level that interest payments constitute the largest single expenditure head of the central government. Non-essential expenditure increased unabated. If one were to focus attention on the central government budget, it is seen immediately that especially during the eighties the revenue acocunt has systematically been showing a deficit (Table A-12). This has meant that the centre has had to repeatedly borrow in the capital market to provide for current expenditure especially non-plan expenditure that yields no return. One immediate consequence of this was that interest liabilities have moved up appreciably. For 1990-91 interest payments formed 16.4 per cent of total expenditure of the central government, as against 9.6 per cent in 1981-82 (Table A-11). A perusal of the economic survey reveals that, gross capital formation out of budgetary resources which comprised 40.1 per cent of total expenditure in 1980-81, had steadily gone down to 32.7 per cent by 1990-91. Two other features need to be mentioned in this context. First, gross capital formation out of budgetary resources which grew at an average rate of 18.8% in the early eighties, appears to have started of decelerating from 1986-87. Secondly, the rate of increase in gross capital formation turned negative (-1.4 per cent) for the first time in 1990-91. In the mean time the gross savings of the government had turned negative for the first time in 1984-85, and dissaving has been growing over the years, amounting to nearly 1.5 per cent of GDP in 1990-91.[16]

All the trends noted above indicates that the government expenditure have bloated way out of proportion to tax and non-tax revenues. The size of the government had grown, and there had been mindless profligacy in sundry projects like loan melas and the loan waivers. The implications of the above trends on the monetary sectors were immediate. Along with the large revenue deficits, the central government has had large budget deficits, averaging about 2.1 per cent of GDP during the seventh plan period (Table A-13). This in turn had contributed to a large monetised deficit which is the total of the net increase in the holdings of treasury bills by the RBI and its contribution to the market borrowing of the government. It is this which determines the growth of money supply. During the seventh plan period the monetised deficit was averaged around 2.3 per cent of GDP. Money supply grew at an average annual rate of about 17 per cent during the first four years of the seventh plan, and wentup by 19.7 per cent during the final year of the plan. This contributed to the double digit increase in the consumer price index inflation during 1990-91.

A major problem with the tax system was that the share of direct taxes had virtually stagnated during the period in reference; it started out at 2.20 per cent of GDP in 1980-81 and averaged around 2.19 per cent of GDP in 1988-89 (Table A-3). Thus, the entire increase in the tax to GDP ratio has been brought about by exploiting indirect taxes.

In financing the seventh plan, the share of domestic borrowings and budgetary deficit far exceeded the targets. Causatively, non plan revenue expenditure, particularly on defence, interest payments and food and fertilizer subsidies rose sharply and exceeded the target.

Thus, we can say that by 1990-91, a severe problem of fiscal stabilization emerged. It was evident that the economy needs substantial fiscal reforms if the crisis was to be fully overcome.

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Chapter - 4

FISCAL STABILIZATION REFORMS IN INDIAN ECONOMY

4.1 INTRODUCTION

The Indian fiscal crisis was precipitated mainly by the growth of the public spending throughout the eighties that increased the budget deficit as a proportion of our G.D.P. At the turn of the decade into the nineties, serious action on the fiscal front was urgently needed to correct the fiscal imbalances. In the event, worsening fiscal deficits and Gulf War of 1990 brought the nation to the brink of international default. An increasing erosion of confidence in the government's ability to manage the economy led to a drying up of the market for external commercial loans in 1990-91. The period from August 1990 to May 1991 also saw a series of steep reductions in the international credit rating of India which had a flawless record of credit worthiness until then.

The state of our public finance had indeed reached crisis proportions by the end of the eighties. The public debt-to-GDP ratio increased through the eighties, going up to over 50 per cent at the end of the decade. As is now well known, the proximate reasons for this situation were the failure of the public sector to generate investible resources and the explosive growth of governmental current spending.

The two OPEC shocks of 1973 and 1979 hurt, but did not have a sustained impact on the budget deficit. The external shocks administered by the loss of remittances and the expenditures incurred to rescue workers in the aftermath of the invasion of Kuwait in August 1990 certainly accentuated the fiscal crisis at the end. But the crisis was certainly 'home made'.[1]

This was the context in which a newly elected government took office in June 1991 and set about the ardous task of launching a programme of economic reforms. To some extent the urgency was derived from the gravity of the crisis because the day of reckoning could not be postponed any further. There was also the performance record of the eighties which clearly pointed towards hastening the pace of structural reforms while setting the fiscal house in order without any loss of time. Fiscal stabilization was begun with a view to bringing about macro-economic stabilization. The regular budget for 1991-92 took a bold step in the direction of correcting the fiscal imbalance. It envisaged a reduction in the fiscal deficit by nearly two percentage points of *GDP*, from 8.4 per cent in 1990-91 to 6.5 per cent in 1991-92. This magnitude of fiscal correction can be considered unprecedented in as much as only eight months of the current fiscal year remained to accomplish the task. The budget laid stress on fiscal stabilization being supported by essential reforms in economic policy and management. While it contained proposals for raising additional revenue, most of the reduction in fiscal deficit was sought to be achieved through reduction in non-plan expenditure.

Part II of this chapter reviews tax reform measures taken by the government. Part III examines steps taken by the government to control unabated growth of expenditure. Part IV covers measures for reforms in public sector enterprises. Final part deals with management of monetary policy.

4.2 TAX REFORM MEASURES

Over the decades since the 1950s, the Indian taxation system became unduly complex, economically unjustifiable and unsatisfactory in many respects. Special exemptions and preferences abounded, nominal rates were high, evasion was widespread, and the burden across tax payers was often unfair.[2]

Revenue mobilisation has been high in India by developing country standards, and the tax/GDP ratio continued to rise in 1980s. However, tax increases were narrowly based and distortionary, mainly involving custom duties and union excise duties. Direct taxes contributed nothing to the increases, and personal taxes fell significantly as a share of GDP.

Customs duties are easy to collect, so there is an administrative factor involved, and same is true of excise duties. Many indirect taxes are set at a specific amount rather than as a percentage to avoid valuation problems. The personal income tax base has been kept narrow by pressure form organised sector employees for increases in the exemption level, together with difficulties in assessment and collection. Farmers have prevented any serious taxation of agricultural incomes by the states and the land tax has sharply declined as a source of revenue.

The thrust of fiscal management in 1991-92 was to meet the challenges posed by the unparalleled fiscal being faced by the country. Measures in the field of direct taxes were targeted at reversing the declining trend in the share of these taxes in total tax revenues and as a proportion of GDP. The objectives of changes in indirect tax regime were : reducing excessive reliance on custom duties for additional resource mobilisation, ensuring price stability for essential commodities and goods improving the competitiveness of the industrial sector, particularly the export-oriented industries.[3]

The budget also emphasised the need for rationalisation of the tax system including, reduction in the plethora of concessions, and also the need to bring the rates of income tax at various slabs of income to more appropriate levels.

Broadly, tax reforms are envisaged to :

* make excise rates more uniform,
* introduce a form of VAT,
* avoid high indirect taxes on capital goods because they are a serious obstacle to international competitiveness and should be lowered drastically,
* strengthen personal income tax by holding exemption limits constant in nominal terms to widen tax base,
* raise taxes on fringe benefits, housing and vehicles,
* rely more on income tax deduction at the source where appropriate, and
* broaden the tax base and increase revenue mobilisation at the state level.

Fiscal stabilization requires a reduction in the fiscal deficit. While some of this can be achieved by reducing low priority expenditure, much of the improvement has to come from higher tax collections. These are best achieved not by high taxation rates which encourage evasion, but by systems that are simple to administer, are set at moderate rates and have a broad base.

In its report the Chelliah committee[i] has recommended far reaching changes in the tax system to remove loopholes besides making it more efficient from revenue raising point of view. The Chelliah committee recommended extensive reform in its Interim Report in August 1992. The government took several steps in this direction in the 1992/93 budget, accepting the approach and the broad lines of reform advocated in the Committee's Interim Report (1991a)[4] and agreeing with the recommendations in the Committee's Final Report (1992a)[5]. The 1994/95 Budget proposals closely followed the recommendations of the committee, emphasising tax reforms aimed at simplifying the structure and continuing the process of shifting to moderate rates of taxation.

In respect of particular taxes the Chelliah committee has, recommended the following :

* In order to make the country's direct tax system more effective it is necessary that the income tax regime has lower rates of taxation with a narrower spread between the entry rate and maximum marginal rate, and a minimum of tax incentives.

* The system of subjecting the income of both partnership firms as well as the partners to taxation amounted to double taxation and this should be avoided.

* Corporation tax rate for domestic companies being high should be lowered to 40 per cent and the surcharge should be abolished. Tax rates for foreign companies should also be lowered and the differential between the tax rates on domestic and foreign companies should be around 7.5 percentage points and in no case to exceed 10 percentage points.

* The present tax treatment of long-term capital gains is not correct because the deductions allowed in computing taxable gain is not related to the period of time for which the assets have been held.

* For levying wealth tax, distinction is to be made between productive and non-productive assets. By exempting productive assets such as shares, securities, bonds, bank deposits etc. from wealth tax the government can encourage investment in them.

* The Chelliah Committee, which was asked to look into all aspects of customs duties, has recommended reduction in the general level of tariffs, a reduction in the dispersion of the tariff rates and a rationalisation of the system with abolition of numerous end use exemptions and concessions. It also suggested that the process of reform should be gradual, so as to moderate the impact of the adjustment both in terms of possible revenue loss and the pace at which industry is exposed to competition.

* At pressent excise duty is levied on advalorem bases on some commodities and at specific rates on others. Over the years for administrative reasons, ad valorem duties have been steadily replaced by specific rates. Advalorem duties are preferable to specific duties as they ensure buoyancy in revenue. Underlining this fact the committee has recommended switching over to advalorem rates for a number of commodities.

The government has decided to implement the recommendations of the Chelliah Committee in a phased manner.

4.2.1 Indirect Taxes

Customs duties are to be further lowered to make key imported raw materials and capital goods available to Indian industry at reasonable cost and to reduce the high levels of protection to domestic industry. Reforms to the excise tax structure aim to promote growth of manufacturing output and employment; simplify tax administration and reduce the scope for misclassification, evasion and disputes; increase revenue elasticity; and pave the way for an eventual VAT.

4.2.2 Direct Taxes

The 1994-95 budget followed the basic approach to tax reform : simplify the system, apply moderate rates, place much greater reliance on broadening the base and improve administration.

4.2.3 Rate Reductions

Reductions in the peak rates of major taxes between 1990-91 and 2000-2001 are setout in Table B-1. It can be seen that among all these

TABLE : B-1

PEAK RATES OF DIFFERENT CENTRAL GOVERNMENT TAXES DURING : 1990-91 to 2000-2001

Year	Income tax		Corporate Tax		Custom Duty
	Basic	Surchage	Basic	Surcharge	(Peak rate)
1990-91	50	8	40	8	200
1991-92	50	12	40	15	150
1992-93	40	12	45	15	110
1993-94	40	12	45	15	85
1994-95	40	-	40	15	65
1995-96	40	-	40	15	50
1996-97	40	-	40	7.5	50
1997-98	30	-	35	-	40
1998-99	30	-	35	-	40
1999-2000	30	10	35	10	40
2000-2001	30	15	35	10	35

Source : Government of India, Ministry of Finance, Budget Documents, Various Issues.

taxes, the decline in the peak rate of customs duty has been phenomenal. It decline from 200 percent in 1990-91 to 35 percent in 2000-2001. The peak rate of income tax has also declined from 50 to 30 per cent. Including the surcharge on income tax, the effective rate of reduction has been from 54 per cent to 34.5 per cent. The effective rate of income tax increased to 56 percent in 1991-92 due to the increase in surcharge from per cent in 1990-91 to 12 per cent in the next year. In respect of corporate tax, the effective reduction has been from around 43 per cent in 1990-91 to 38.5 per cent in 2000-2001.

Even though the peak rate of income tax and corporation tax have declined substantially between 1990-91 and 2000-2001, decline in rates has been done in a phased manner. In the case of the income tax rate, reduction has taken place in four different time parts. First in 1992-93, when it was reduced from 50 per cent to 40 per cent. Second phase began in 1994-95 with the removal of surcharge which reduced the effective rate of tax even though the basic rate of 40 per cent continued till 1996-97. Third in 1997-98, when it was reduced from 40 per cent to 30 per cent, fourth phase began in 1999-2000 with the reintroduction of surcharge over the basic rate of 30 per cent which resulted in the increased effective tax rate, and the same has been continued in 2000-2001 with nominal increase in surcharge. In the case of corporate tax, the peak rate declined from 40 per cent to 35 per cent between 1990-91 and 2000-2001. In between there was an increase in the peak rate from 40 per cent in 1991-92 to 45 per cent in 1992-93 and this rate of 45 per cent remained till 1993-94 alongwith surcharge of 15 percent. Between 1994-95 and 1995-

96, corporate tax remained at 40 per cent with a surcharge of 15 per cent. In the subsequent two years there has been year-to-year reduction in the rate of corporate tax below 40 per cent (due to the reduction in surcharge to 7.5 per cent) and 35 per cent respectively. However, with the reintroduction of surcharge in 1999-2000, effective rate of corporate tax increased, which has been continued in 2000-2001.

Recent Reforms

Reform of the tax system has been an important element of structural reforms. The strategy has aimed at moving towards a simpler system of taxation with moderate rates, few exemptions and a wider tax base. The 1994-95 budget has continued to rely on these principles in direct taxes and undertaken major structural reform of indirect taxation.

In regard to both excise and customs, there has been a drastic cut in the number of end use notifications, which will greatly reduce the possibility of disputes and scope for discretion. Besides, the number of rate categories was sharply reduced, the peak rates were brought down and a significant switch over was effected from specific to advalorem duties to strengthen built revenue elasticity. The system of credit for taxes paid on inputs, called MODVAT, was extended to cover petroleum and capital goods.[6]

These changes in commodity taxation have brought MODVAT closer to a VAT type system, and will facilitate the introduction of a full fledged Value Added Tax. A modest beginning was also made in extending indirect taxation to services such as, telephones, non-life insurance and stock brokers.

In the budget of 1996-97, an effort has been made to tackle the phenomenon of zero tax companies having substantial book profits by bringing such companies under Minimum Alternative Tax (MAT)[iii]. However, the companies in power and infrastructure sector or a sick industrial company or companies located in backward areas entitled to exemption under section 80 1A, have been kept out of the purview of MAT. The tax under MAT would in reality workout to about 12 per cent only. MAT has been now reduced to 7.5 per cent in the budget of 2000-2001.

The budget 1997-98 proposes two major innovations in the direct tax proposals i.e. (i) amendment of section 139 A of the Income Tax Act and (ii) the introduction of Voluntary Disclosure Scheme (VDS) to tap black money. Amendment of section 139 A proposes to widen the tax base by bringing the residents of larger metropolitan cities within the tax net on the basis of their lifestyle [iv]. To tap black money, under VDS, it is proposed that the disclosed amount either in the form of cash, securities or assets, whether in India or abroad, would be charged at the revised highest rate (30 per cent) of tax without any interest, penalty and action under the income tax, wealth tax and Foreign Exchange Regulation Act.

Regarding excise duty, the finance minister has proposed a gradual movement towards a mean rate of 18 per cent in order to reduce dispersion in excise rate in the budget of 1997-98 with this objective, three new rates have been introduced, namely, 8 per cent, 13 per cent and 18 per cent compared to the previous rates of 20 per cent and 10 per cent (except in the case of some petroleum products). The 1999-2000 budget undertook a major overhaul of indirect taxes by reducing the multiplicity of rates, rationalising the rate structure and drastically curtailing the scope for discretion by abolishing the power to grant ad-hoc duty exemptions. It reduced number of duty rates for excise from 11 to 3. The cap on MODVAT credit of 95 per cent of the admissible amount was lifted and restored to 100 per cent. Further, it also indicated government's intention to move towards a single rate and a full-fledged VAT in the medium term. In the budget of 2000-2001, the major measure on the tax side is the introduction of the single rate Central VAT (CENVAT). This has merged the prevailing three advalorem rates of 8, 16, and 24 per cent into a single rate of 16 per cent. At the same time special excise duty (SED) at three rates, which are not MODVATable has been introduced.

On customs, the peak rate has been reduced by five points. As far as personal income tax is concerned, there was no change in the rate except minimal increase in the surcharge. On these tax measures M. Govinda Rao argues that, "while there can be no dispute about the direction of reforms, this can not be considered significant to initiate the second phase of reforms. On the issue of personal income taxes, no change cannot be considered as a good policy always. It was possible to simplify the personal income tax system by abolishing surcharge and rationalise savings incentives.[7]

4.3 MEASURES TO CONTROL PUBLIC EXPENDITURE

Government expenditure has risen faster than GDP all over the world during the last several decades. Basically there are three reasons for this : (a) advent of socialism, and mixed economy; (b) rise of welfare state, and (c) predominance of keynesian stabilization Policy.

In pure socialist countries the government does all the key economic activities. The share of government expenditure tends to grow with the degree of socialism in a mixed economy. In the welfare state the state takes the responsibility to provide education, health services, basic social infrastructure and social security. Keynesian stabilization policy with government expenditure as a key regulator of aggregate demand and supply provided the third impetus to the growth of public expenditure, especially in the industrial countries.

In the five decades of economic planning in India the share of government expenditure in GDP has increased from 10 per cent to about 35 percent. The growth has been more or less uniform in all decades. The share of government expenditure in GDP in India is five percentage points above the average of low-income countries.[8]

There had been an unsustainable increase in government expenditure. Budgetary subsidies, with questionable social and economic impact, have been allowed to grow to an alarming extent. The increasing difference between the income and expenditure of the government has led to a widening of the gap between the income and expenditure of the economy as a whole. This resulted in a huge fiscal deficit, which was financed by the borrowing. As a result, internal public debt accumulated to about 55 per cent of GDP by 1990-91. The burden of servicing this debt also increased rapidly. Interest payments alone were about 4 per cent of GDP and constituted almost 20 per cent of the total expenditure of the central government.

The Budget for 1991-92 took some major steps to control the rapidly growing expenditure:

(i) Reduction in the Fertilizer subsidy by increasing the average prices of fertilizer by 30 per cent.

(ii) Abolition of subsidy on sugar distributed through the Public Distribution System (PDS).

(iii) Abolition of Cash Compensatory support for exports.

(iv) A 20 per cent increase in the prices of motor spirit, domestic LPG and aviation turbine fuel for domestic use.

After the budget for 1991-92 was passed, the government also imposed a 5 per cent cut on the expenditure provisions contained in the sanctioned budget estimates for 1991-92 of all ministries/departments.

4.3.1 Cutting Non-Plan Expenditure

Concept of Non-Plan expenditure as explained in the expenditure Budget is as follows:

"Non-plan expenditure is a generic term used to cover all expenditure of government not included in the Plan. It includes both developmental and non-developmental expenditure. Part of the expenditure is obligatory in nature e.g. interest payments, pensionary charges and statutors to states. Part of the expenditure is an essential obligation of a state e.g. defence and internal security. Then, there are special responsibilities of the centre like external affairs, and currency and mint, and cooperation with other developing countries. Expenditure on maintaining the assets created in previous plans is also treated as non-plan expenditure. Similarly, expenditure on continuing services and activities at levels already reached in a Plan period is shifted to Non-Plan in the next Plan e.g. educational and health facilities, continuing research projects and operating expenses of power stations. Thus as more plans are completed a large amount of expenditure on operation and maintenance of facilities and services created gets added to Non-Plan expenditure, besides the interest on borrowings to finance the Plan"[9]

4.3.2 Interest Payments

Interest payments which contributed most to the fiscal imbalance have continued to rise. According to Raja J. Chelliah, "The net interest payments by the government can be reduced by bringing down the gross interest payments or by increasing the income form the government's investments. It does not seem feasible to increase the latter. It is, therefore, necessary to find ways of reducing the gross interest payments by the government."[10]

As a proportion of GDP, the central government's outstanding internal debt[v] rose from 35.6 per cent in 1980-81 to 53.3 per cent in

1990-91. During the same period, gross interest payments on internal debt, as a proportion of GDP, more than doubled, as they rose from 1.7 per cent to 3.7 per cent. Other measures of growth in gross liabilities show more or less similar increase. As can be seen from Table: B-2, as a proportion of the centre's total expenditure, these payments showed an escalation from 10.5 per cent to 18.7 per cent during the same period; as a proportion of the revenue account expenditure from 15.4 per cent to 26.1 per cent; as a proportion of revenue receipts from 18.1 per cent to 34.6 per cent and as a proportion of tax revenues from 24.6 per cent to 45.7 per cent. All funds borrowed by government need not be and are not actually, deployed in investments, physical or financial. But the portion so deployed, particularly that made in financial investments, does yield returns, and that too directly in the form of interest receipts, dividends and profits. In 1980-81 as much as 84.3 per cent of the interest paid on the total public debt of the centre was recovered as interest receipts, dividends and profits.[vi] Compared to that, the amount recovered in 1990-91 worked out to 44.5 per cent. Thus, while the centre's debt mounted and its gross interest obligations increased, correspondingly its recoveries declined, which resulted in a greater burden on the general budget. Between 1980-81 and 1990-91 the central government's revenue receipts, as a proportion of GDP increased from 9.4 per cent to 10.7 per cent and tax receipts from 6.9 per cent to 8.1 per cent During the same period, annual growth registered in GDP was of the order of 5.5 per cent whereas net borrowing (including borrowing from RBI) of the central government increased from 6.6 percent to 8.6 per cent and gross interest obligations

TABLE : B-2

GROSS INTEREST PAYMENTS BY CENTRAL GOVERNMENT

Gross Interest as percentage of	1980-81	1990-91
1- GDP	1.7	3.7
2- Total Government Expenditure	10.5	18.7
3- Revenue Expenditure	15.6	26.1
4- Current Revenues	18.1	34.6
5- Tax Revenues	24.6	45.7

Source : Government of India, Ministry of Finance, Economic Survey, 1992-93.

increased from 1.9 per cent to 4 per cent of GDP. Obviously, the increase in the central government's receipts as well as in its tax receipts has been far below the increase in its gross interest obligations.

By targeting the fiscal deficit, government have sought to focus attention on containing public borrowing regardless of not only whether it takes the form of borrowing from households, or from banks or from the RBI but also what the funds raised in public borrowing could have been used for by the government. Strictly speaking when the proponents of the concept speak of the fiscal deficit, no distinction is drawn between covering the fiscal deficit through external public borrowing and through internal public borrowing. We shall, however assume for over purpose that the fiscal deficit, whatever be its magnitude, is covered through internal public borrowing. To emphasize reduction in public borrowing in order to reduce the fiscal deficit amounts to shifting the accent of fiscal policy from the mobilisation of current revenue receipts and the productive deployment of government expenditure. One can not rule out the possibility that a stage may arrive when blanket reduction in government spending may be called for.

Government has no other option except to effect reduction in the existing stock of debt. Since it is not possible to create a surplus in the account of balance of payments for reducing external debt, debt reduction has to confined to internal debt. The resources for this purpose can be raised by disinvesting in public sector enterprises and selling a part of vast real estate that the government owns in the country.

It will be appropriate at this point to refer to the paper written by E.D. Domar in 1944. This paper was no doubt, written in the context of the post-world war II fiscal policy in the US, but it is relevant to the current discussion in our country on fiscal policy. In this paper Domar argued that :

"When post-war fiscal policy is discussed, the public debt and its burden loom in the eyes of many economists and layman as the greatest obstacle to all good things on earth. The remedy is always the reduction of the absolute size of the debt or atleast the prevention of its further growth. If all the people and organisations who work and study,write articles and make speeches, worry and spend sleepless nights - all for fear of the debt - could forget about it for a while and spend even half their efforts trying to find ways of achieving a growing national income their contribution to the benefit and welfare of humanity and to the solution of the debt problem would be far greater".[11]

4.3.3 Other Non-Plan Expenditures

In India, there is not much scope for raising tax revenue. Chelliah argued that 'neither it is feasible nor desirable to plan for a buoyancy in tax revenues of more than 1.1 or so'.[12] Therefore, if fiscal deficit is to be brought down the growth of all the major categories of non-interest expenditure has to be slowed down considerably. In some cases it is both desirable and feasible to effect reduction in the expenditure. From this point of view subsidies, capital assistance to non-viable and inefficient enterprises, government's and defence expenditure have been specially mentioned.

The second largest component of non-plan expenditure is the allocation for the defence sector. No attempt at containing non-plan expenditure can succeed if defence is to be excluded. Containment of the growth of defence expenditure involves some security risk. Nonetheless, it is generally agreed that there is considerable scope to enhance the cost-effectiveness of the defence expenditure. In case this task is undertaken earnestly, then there is no reason why at least in the short-run, defence expenditure on revenue account can not be kept constant in real terms. Defence revenue expenditures have been more or less contained in 1999-92 over 1990-91. In this regard then Finance Minsiter Dr. Manmohan Singh in his first budget speech stated that :

"it is absolutely essential to ensure that a quest for economy in expenditure does not in any way compromise national security. We must, therefore, seek to limit expenditure without diluting the efficiency and effectiveness of our defence services".[13]

Unfortunately, the volume of subsidies has been accelerating with time mainly because of vested political interests. Over-protection through subsidies has prevented the potential competitiveness of the system from being realised. Beyond a point, however, the fiscal system cannot absorb such subsidies. In principle though the government decided to cut down subsidies, in practice it failed to do that. The government has reduced the export subsidy but is finding it difficult to cut down the fertiliser and food subsidies due to resistance from the big farmers' lobby. As far as food subsidy is concerned, it should be drastically pruned and in any case should be provided to the lower strata of the society only. Export subsidies have been abolished with effect from 3 July 1991. The export sector is being adequately compensated through the adjustments in the exchange rate and the expansion of the Replenishment Licensing System[vii] which were implemented at the beginning of July 1991. So far as fertiliser subsidies are concerned, there was an increase of 40 per cent, on an average, in the price of all fertilisers except low analysis fertilisers such as calcium ammonium nitrate, ammonium chloride, ammonium sulphate and sulphate of potash were made free from price and movement controls in the budget of 1991-92. The sugar subsidy which was costing the exchequer about Rs. 350 crore per annum was indeed an aberration, which crept into the system from January 1990, when the increase in the levy price paid to producers was not matched by a simultaneous increase in the issue price for consumers in the public distribution system, government has decided that this subsidy should be abolished forthwith. Consequently, the issue price of sugar under the PDS was increased by 85 paise per kg. with effect from 24 July 1991. Subsidies on food distributed through PDS were reduced in recent budgets. Prices of petroleum products for domestic consumers also raised. The price of motor spirit, domestic LPG and aviation turbine fuel for doemstic use was raised by 20 per cent. The price of other petroleum products, excluding diesel and kerosene for non industrial use was raised by 10 per cent.

In his budget speech of 1991 Finance Minister Dr. Manmohan Singh addressed the matter of cut in non-plan expenditure in this way :

"As a result of the major adjustments in the sphere of expenditure, which I have outlined in my speech, the budget estimate for total non-plan expenditure in 1991-92 stands at Rs. 79,697 crore. It is simply not possible to reduce interest payments in the short term. The provision for non-plan expenditure, excluding interest payments, in the current year represents a reduction of 4.9 per cent compared with the provisions in the revised estimates for 1990-91, and a reduction of almost 15 per cent in relation to what we would have had to provide this year, but for the specific correctives that are being introduced".[14]

As a part of the government's policy to supplement fiscal stabilization by structural reforms in economic policy and management, the government initiated steps to prioritise the activities and schemes both on plan and non-plan side to identify those which could be eliminated or reduced in size. In September, 1991 the government had also imposed a 5 per cent cut on the expenditure provisions contained in the sancitoned budget estimates for 1991-92 of all Ministries/Departments. Only a few items of expenditure, such as, statutory grants to state governments, block grants and loans for state plan schemes, interest payments and pension payments were exempted from the expenditure cut. The then Finance Minister had indicated on number of times that the burden of achieving reduction in fiscal deficit would fall heavily on expenditure side.

4.4 REFORMS OF PUBLIC SECTOR ENTERPRISES

The state dominated heavy industries based on Nehru-Mahalanobis strategy of protected industrialisation which India has pursued since the mid-fifties, required not only a high rate of domestic savings and investment but also a large share for the public sector in total investment. However, the public sector's own savings performance has been quite disappointing. Though public sector savings have been less than public investment throughout the planning period, this gap widened considerably during the eighties. The share of public sector in gross domestic savings declined from over 20 per cent at the beginning of the decade to only 8 per cent by 1989-90. In plan financing, while the sixth plan (1980-81 to 1984-85) envisaged that over 46 per cent of the public sector plan outlay would be financed by own resources of the public sector, the actual contribution turned out to be only 37 per cent. Similarly, during the seventh plan (1985-86 to 1989-90) only 27 per cent of the public sector plan outlay was financed from own resources as against a target of over 41 per cent.

There were 246 central government public enterprises as on March 31, 1991, out of which 236 enterprises were in operation. These 236 enterprises yielded a net profit of Rs. 2368 crore in 1990-91, implying a rate of return of only 2.3 per cent on Rs. 101,797 crore capital employed. Of this, only 69 crores came from all the non-oil public enterprises put together. The record of the state level enterprises is worse. The departmental commercial undertakings of all states and union territories together reported a net loss of Rs. 1885 crore in 1990-91. Of the two major types of non-departmental undertakings, the State Electricity Boards reported a combined loss of Rs. 4169 crore while the

State Road Transport Corporation reported a loss of Rs. 470 crore. Thus, instead of generating a surplus, all public enterprises put together generated a net loss of some Rs. 4176 crore (Table A-12).

'Pervasive inefficiencies and poor financial performance in public sector enterprises have remained a major obstacle to industrial development and international competitiveness. Inefficiency and lack of dynamism have resulted from cost-plus pricing and distribution controls. Many public sector enterprises have been de facto monopolies, protected from competition. A soft budget constraint - easy access to budget funds and/or credit from the financial sector - has allowed sick PSEs to survive. Ambiguous relationships with government supervisory authorities were not conducive to efficiency. These enterprises have also been constrained by multiple objectives, lack of managerial autonomy and overstaffing pressures in relation to operational needs. They have constituted a serious drain on government resources'.[15]

Reformists argue for a far more concrete exit policy and for reforms to be undertaken at the state level where public enterprises are even less efficient and less profitable than at the national level, and where the effect on limited resources is more serious. The reforms aim to increase efficiency and reduce the losses that so many public enterprises impose on the government budget. It is recognised that the budget not only should not support sick enterprises but it should not even provide the funds for their expansion. Rather, these should come from their own funds or from the capital market.

The 20th December 1991 speech by the Prime Minister elaborated policy on the public sector following the July 1991 new industrial policy.

'The mixed economy will continue but no further nationalisation will be resorted to; there will be no budgetary support to sick or potentially sick PSEs, with a view to eliminating it as soon as possible, but with 'sickness', hardship will be alleviated with the National Renewal Fund'.[16]

The demand for reform of public sector enterprises seems to be more on pragmatic than ideological grounds. As the economic environment is being made more conducive to cost and quality considerations and attempts are being made to foster competition, pressures on performance orientation in the public sector are also mounting. The policy response in the form of public sector reforms by the central government, however, has been slow. Under structural reforms the government has decided to give greater managerial autonomy to public enterprises to enable them to work efficiently. In addition to this, two other key elements of the government's strategy for public enterprise reform are the promotion of increased private sector competition in areas where social considerations are not paramount and partial disinvestment of equity in selected enterprises.

In the area of public sector enterprises following steps were taken by the the government.

* The system of monitoring has been strengthened with Memorandums of Understanding. The MOUs are being claimed in official circles as major instruments of the rollback of state involvement in the running of the public enterprises by citing statistics such as the following : 'During 1990-91, 23 public enterprises signed MOUs with their administrative ministries, of which 14 were evaluated as excellent, 8 as good and 1 as poor. In 1991-92, 71 enterprises signed MOUs, while in 1992-93, 120 enterprises were identified for this purpose'.[17] A more objective assessment of the situation, therefore, calls for a cleaner break with the old traditional culture of running the PSEs through back seat driving. The experience with the MOUs in the past has not been very positive. A change of attitude in the new era of liberalization may lead to some improvement in results in the years to come, but much more is needed than MOUs to distance the government from the actual running of the PSEs.

* Some steps have been taken towards the marketisation of the PSEs. An important aspect of 'Marketisation' is corporatisation.[viii] A major example of corporatisation can be seen in the telecommunications sector. A beginning was made in 1986 by setting up a new corporate entity, i.e. the Mahanagar Telephone Nigam Ltd. (MTNL). The company made a profit of Rs. 1.4 billion in the very first year of its operation. This has now raised expectations.

The loss making sick PSEs have been brought under the ambit of Board for Industrial and Financial Restructuring (BIFR) which was already facing numerous problems dealing with the sick private sector units. The government policy of marginal disinvestment of the equity of public sector enterprises has been dominantly governed by the compulsions of financing the fiscal deficits. The whole disinvestment approach is so incremental and so thinly spread that it fails to address the basic issue of how to improve the very low returns on the capital invested in the public sector. Not much has been done to bring about effective changes in the functioning of these enterprises. The approach of disinvestment is based on the assumption that the induction of private shareholders will alter the corporate culture in these enterprises and provide them a stronger commercial orientation in response to normal shareholder expectations. This is a tall assumption indeed.

The 1991-92 budget earmarked $ 67 million for the National Renewal Fund. The International Development Agency promised over $ 166 million during 1992-93 and the same amount in 1993-94. The NRF is expected to provide assistance to firms undertaking modernisation and technological upgrading of existing capacities to cover the costs of retraining and redeployment of employees. The fund would also provide compensation to employees affected by restructuring or closure of industrial units in both the private and public sectors. A social safety net would be provided for workers through allocating funds to finance employment generation schemes in the organised and unorganised sectors.

The willingness of the government to form strategic alliances has been demonstrated in the case of Maruti Udyog Ltd. an automobile joint venture with Suzuki Motor Corporation of Japan. This unit was originally set up in the early eighties with Suzuki having a 40 per cent stake and the Government of India the remaining 60 per cent. Later, as part of the policy of encouraging foreign investors to increase their shareholding, Suzuki was allowed to increase its share holding to 50 per cent by purchase of fresh equity and also to acquire greater management control.

* On the whole the reforms of PSUs including privatization and phasing out of unviable units have not gathered as much momentum as had been hoped for. Disinvestment has been piecemeal and the funds so raised are being used to reduce budget deficits, rather than strengthen the PSUs. As Bimal Jalan points out :

'The sale of public sector enterprises would be of little help unless macroeconomic environment is improved and it is quite probable that if macroeconomic stabilization is successful, disinvestment of equity in public sector enterprises may not be necessary'.[18]

Along with this, labour problems, political and bureaucratic interference have not been effectively reduced. Since it is not possible to privatise a large component of the public sector, it would be advisable to reform it.

4.5 FINANCIAL SECTOR REFORMS

We are aware now that the economic reforms launched by the government in 1991 were designed to accelerate overall growth and help India realise its full productive potential. The experience of successful developing countries indicates that rapid growth requires a sustained effort at mobilising savings and resources and deploying them in ways which encourage efficient production. Financial sector reform thus constitutes an important component of the programme of stabilization and structural reform. At the outset the government had recognised that financial sector reform was an integral part of the new economic policy. A high level committee headed by Mr. M.N. Narsimham was appointed to consider all relevant aspects of the structure, organisation, functions and procedures of the financial system. Following the committee's report in November 1991, the government embarked on a far reaching process of reform covering both the banking system and the capital market.

4.5.1 Reforms in the Banking System

At the time of the crisis in 1991, India had been successful in mobilising savings, but the financial system had been seriously weakened by government policies. Commercial banks operated at low margins due to obligations to provide credit at subsidised rates to government and priority sectors. Internal efficiency in commercial banks was low and administrative costs were high. Many of the problems stemmed from fiscal deficits and the RBI's attempts to counter the potential monetary effects of deficits by requiring commercial banks to hold extensive government debt at below market rates. Solutions depended to a large extent on regaining fiscal balance.

'A basic constraint on the efficient functioning of the banks has been the preemption of large proportion of bank funds at low rates of interest for financing the fiscal deficits through the Statutory Liquidity Ratio (SLR) has already begun in the budget of 1992-93 when the average SLR of 38.5 per cent was lowered to 36 per cent. The budget for 1993-94 sets the goal of bringing it further down to 25 per cent at the end of three years but does not specify the phasing pattern'.[19]

The process of fiscal stabilization is expected to reduce the government's demand for borrowed funds and will facilitate the process of lowering the SLR. The interest rate structure has also been simplified. One of the problems facing the banks in 1991 was that levels of statutory liquidity ratio and cash reserve ratio (CRR) had been progressively increased over the years : the SLR, because of the desire to mobilise increasing resources through so-called market borrowings to support the central and state budgets. In the case of the CRR, it was because of the need to counter the expansionary impact on the money supply of the large budget deficits. Together, the SLR and CRR stipulation directed a large proportion of bank resources into low income-earning assets, reducing bank profitability and pressuring banks to charge high interest rates on commercial sector advances. The SLR and CRR were in fact a tax on financial savings in the banking system encouraging distortionary flows in markets where this tax did not apply. The government decided to phase out this distortion. The SLR is to be reduced in stages from 38.5 per cent to 25 per cent, and the CRR is to be reduced to a level below 10 per cent.

The government initiated a number of short-term measures to improve the financial sector, and pave the way for future reforms :

* A high level committee, the Narsimham committee on financial sector Reforms (1991), reviewed the structure, organisation, functions and procedures of the financial system.
* Interest rates on term loans and on the bulk of debt instruments in capital markets have been decontrolled, and deposit interest rates have been increased.
* Full statutory powers were given to the Securities and Exchange Board of India (SEBI) to regulate, promote and monitor Stock Exchanges in India.
* The private sector is now allowed to establish mutual funds.

The central government has been strongly influenced by the findings and recommendations of the Narsimham committee on financial sector reforms (1991), and by the securities scam. The government has recognised the sector as being over-regulated and overgoverned. In this situation, the quality of the advances portfolio has deteriorated and a culture of non-recovery has developed in many parts of the banking system. A number of reform initiatives to cover bad debts and meet new capital adequacy norms were announced in 1994 and special arrangements are in train for the recovery of debt due to banks.

4.5.2 Reforms of the Capital Markets

In addition to banking system reform, it was also necessary to reform the capital market, a need which had been evident for some time. Stock exchanges, for example, are characterised by long delays, lack of transparency in procedures, and vulnerability to price rigging and insider trading. To counter these problems the government moved to establish a Securities and Exchange Board of India in the 1987-88 budget. It was first established as a non-statutory board, with the intention of giving it statutory powers, but this did not happen until January 1992.

Recommendations for reforms in the capital market were made by the Narsimham Committee (1991) and a series of initiatives were undertaken in 1991-92 and 1992-93. 'The reforms are moving capital markets away from direct government control over volume and pricing of issues to a market-determined system regulated by an independent authority. The government has recognised that the process of reform in the capital market has only begun'.[20]

Further reform is necessary to bring about speedier conclusions of transactions, greater transparency in operations, improved services to investors, and greater investor protection, while encouraging the corporate sector to raise resources directly from the market at an increasing scale. Modernisation of the stock exchanges to bring them into line with world standards in terms of transparency and reliability is also necessary if foreign capital is to be attracted on any significant scale. A number of Indian companies have been successful recently in raising funds abroad through Euro-Equity issues and foreign currency convertible issues.

Finally, we would like to stress here that nearly half of the gross fiscal deficit of the central government in 1990-91 was financed by the banking system (including the RBI). Through instruments such as the mandatory cash reserve ratio and statutory liquidity ratio, the government has traditionally forced the commercial banks to hold a larger share of relatively low-yielding government liabilities in their asset portfolio than they would otherwise hold. In any event, the facts that important financial intermediaries such as the major commercial banks and the Life Insurance Corporation are in the public sector, and that the Reserve Bank of India does not have the autonomy of either the federal Reserve Bank of the United States or the Bundesbank of Germany, have meant that the central government has faced little external discipline to trim its fiscal scales for fear of being unable to finance its deficit at any inflationary cost. This means that the reform of the financial sector, including of the RBI, must be treated as an integral part of the fiscal reforms.

The foregoing review has dealt with only urgent issues in fiscal stabilization reforms. Such as the deficit, expenditure control, reform of the tax system, banking and financial sector reform, subsidies and public sector reforms. In India, the fiscal instability has been mainly caused by sharp rise in public expenditure. Therefore, reduction in the fiscal deficit is to be brought about by containing public expenditure. Although for the purpose of fiscal stabilization containment of the government expenditure should receive priority, some effort at additional resource mobilisation through tax and non-tax sources may also be necessary. The planning commission has stated :

'The required additional revenues may have to be generated by a judicious mixture of broadening the tax base, rationalising the tax rates and through non-tax sources'.[21]

An area where there is considerable scope for revenue mobilisation is public services. User charges on publicly provided utilities such as irrigation, electricity, water, road transport and higher education are much below their cost of provision. Hence, unrecovered costs of public utilities are large and a kind of subsidy to the users. The government can justifiably raise user charges on public utilities like electricity, irrigation, transportation and water. But it has to be said in conclusion that fiscal policy is more than the mere arithmetic of budgets or even the formal process of financial management in government. To lose sight of the underlying political power relations which drive fiscal policy is to miss the central point about the roots of India's current fiscal crisis.

NOTES

i) A Tax Reforms Committee was constituted under the Chairmanship of R.J. Chelliah in 1991 to examine the tax structure in the country and make appropriate recommendations to reform it.

ii) MODVAT was introduced with effect from 1.3.1986. Under the MODVAT scheme credit of duty is allowed on inputs which are used either for producing excisable finished products or intermediate products.

iii) MAT applies where the total income of a company as counted under the Income Tax Act, after availing all eligible deductions, is less than 30 per cent of the book profit. The total income of such companies shall be deemed to be 30 per cent of the book profit and shall be charged to tax accordingly.

iv) It has been proposed that residents of large metropolitan cities, who satisfy two of the economic criteria, namely ownership of a four wheeler vehicle, occupation of immovable property meeting certain prescribed criteria : ownership of a telephone and foreign travel in the previous year should fall within the taxable slab and should voluntarily file their tax return.

v) The term 'internal debt' is used to cover the various liabilities of the Government which in official documents referred to as 'internal liabilities' including what is narrowly called 'internal debt'.

vi) While interest payments are shown in the official documents separately for internal and external debt, interest receipts, dividends and profits are not so shown. The practice so far followed in the official documents is to put out also figures of total net outgo on account of interest payments.

vii) In order to provide the export sector of the eocnomy with access to importable inputs that enter into export production, at international prices, the import policy allows special import facilities for registered exporters.

viii) Corporatisation means creating institutions which are distinct from a government department and operate as separate entities enabling commercial approach to the activities of the public sector.

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Chapter - 5

EFFECT OF FISCAL REFORMS ON FISCAL STABILIZATION IN INDIAN ECONOMY (1991-92 to 1999-2000)

5.1 INTRODUCTION

The most significant caveat of the economic reforms has been the management of the fiscal deficit during the 1990s. After an initial improvement in the fiscal deficit in 1991-92, the government faced difficulty in controlling the fiscal deficit/GDP ratio. The tax/GDP ratio also declined and the central government passed down certain expenditure responsibilities to state governments thereby managing to reduce the expenditure/GDP ratio to some extent.

This chapter focusses on the effects of the fiscal stabilization measures on the performance of the fiscal sector and direction for future policy imperatives. On the expenditure side, the government has admitted that strong improvements and imperative in the area of expenditure control. The principal factors underlying India's fiscal imbalance are the runaway growth of public expenditure and poor performance of public enterprises. On the revenue side, between 1990-91 to 1994-95 the tax/GDP ratio marginally declined. This happened in the context of a reform. It is certainly true that distortions prevailing in the earlier tax structure were reduced. The cascading effect of the taxes was reduced. The number and level of rates under each major tax were scaled back. But the reform measures were unable to eliminate distortions or the unequal treatment of taxpayers caused by the many remaining exemptions from the various taxes. The result was that the tax base remained narrow even as average tax rates were reduced across the board.

A tax package that reduces rates but fails to expand the base will have three results :

1. It will be popular;
2. The tax/GDP ratio will tend to be sluggish; and
3. The tax administration will genuinely have to improve.

All these results could be said to have followed a reduction in the tax contribution in terms of GDP would be acceptable if fiscal deficit/ GDP ratio was not high. Until 1995-96, government was clearly unable to meet its deficit objective. The weight of the correction then would have to be borne by an increased tax/GDP ratio of expenditure could not be controlled. But the reverse happened over a five-year period in the 1990s. Even short-term tax administration measures, however ardent, have failed to raise back the tax/GDP ratio back to historical levels, including the level prevailing at the beginning of the crisis period particularly in 1990-91.

In what follows, section II summarises revenue trends including tax reforms and their revenue implications. Section III presents a description of expenditure trends and needed improvements in the control and quality of expenditure. Section IV discusses the role of fiscal stabilization measures in the management of public debt. Section V evaluates the impact of public sector reforms on fiscal stabilization. Section VI makes concluding remarks on the overall state of the fiscal stabilization and on the agenda for future reform.

5.2 REVENUE : TRENDS AND NEEDED IMPROVEMENTS

5.2.1 Tax Reforms and Their Revenue Implications

The Process of fiscal stabilization initiated in 1991 as part of the structural adjustment programme advocated for reduction in fiscal deficit. Bringing down the fiscal deficit to the targeted level is backed by the expected high revenue buoyancy. This expectation is based on the assumption that the proposed lowering of the rates of income tax, corporate tax, and excise and customs duties would result in higher tax revenues and thereby help in reducing the fiscal deficit.

The fiscal deficit reduction is considered as the precondition for higher economic growth. And when economic growth accelerates, it should result in higher tax revenues. To the extent this reasoning is valid, first fiscal deficit should come down and should reflect in terms of higher private investment. Then higher growth of income should generate larger tax revenues. This raises the question of time lag. If however, the tax rate reduction has to have an impact on current tax revenues without any time lag, the line of reasoning behind the expected buoyancy in revenues has to be different. Finance Ministry officials have justified the expected immediate buoyancy in central tax revenues on the belief that the Laffer curve[i] phenomenon starts to operate almost instantly. The rationale behind Laffer curve is that high tax rate adversely affects the growth of income and the fall in income would result in more than proportionate fall in tax revenue. Therefore, reduction in tax rate is essential for higher growth of income and tax revenue. This again raises the question of time lag. If, in the short period, the Laffer curve phenomenon has to operate, there should be a negative functional relationship between the tax rate and the tax base. Increase in tax base should lead to better compliance. It means that there should be a negative rate elasticity, since better tax compliance is supposed to makeup for the loss in revenue on account of reduction in the rate of tax. However, if the tax base remains unaffected by the lowering of tax rate, total tax revenue would obviously fall. Earlier studies on this issue had shown that contrary to the popular belief, the Laffer curve phenomenon does not operate in the Indian context. Studies on direct taxes in India showed that lowering of tax rate did not result in higher tax mobilisation in the past. Bagchi and Rao[1] tested the validity of this relationship. In their analysis estimating the growth of assessed income without any change in the tax rate prevailing in the previous year and the assessed income, introducing the change in the tax rate, they found that revenue loss was not being compensated by better compliance because of the lowering of tax rate. Here, we attempt to examine whether in recent years the lowering of tax rates has actually resulted in higher tax mobilisation and what is our experience during the post reform period?

What we do in this study is to show how tax collections have fared while GDP and Non-Agricultural GDP (NAGDP) changed over the years, as tax rates underwent alterations.

5.2.2 Tax GDP Ratio

If the reduction of tax rates is the appropriate measure to increase revenue collection, increased revenue buoyancy should have been reflected in higher tax GDP ratio. But as far as total central tax revenue to

TABLE : C-1

VARIOUS TAX REVENUES OF THE CENTRAL GOVERNMENT AS PERCENTAGE OF GDP (1990-91 to 1999-2000)

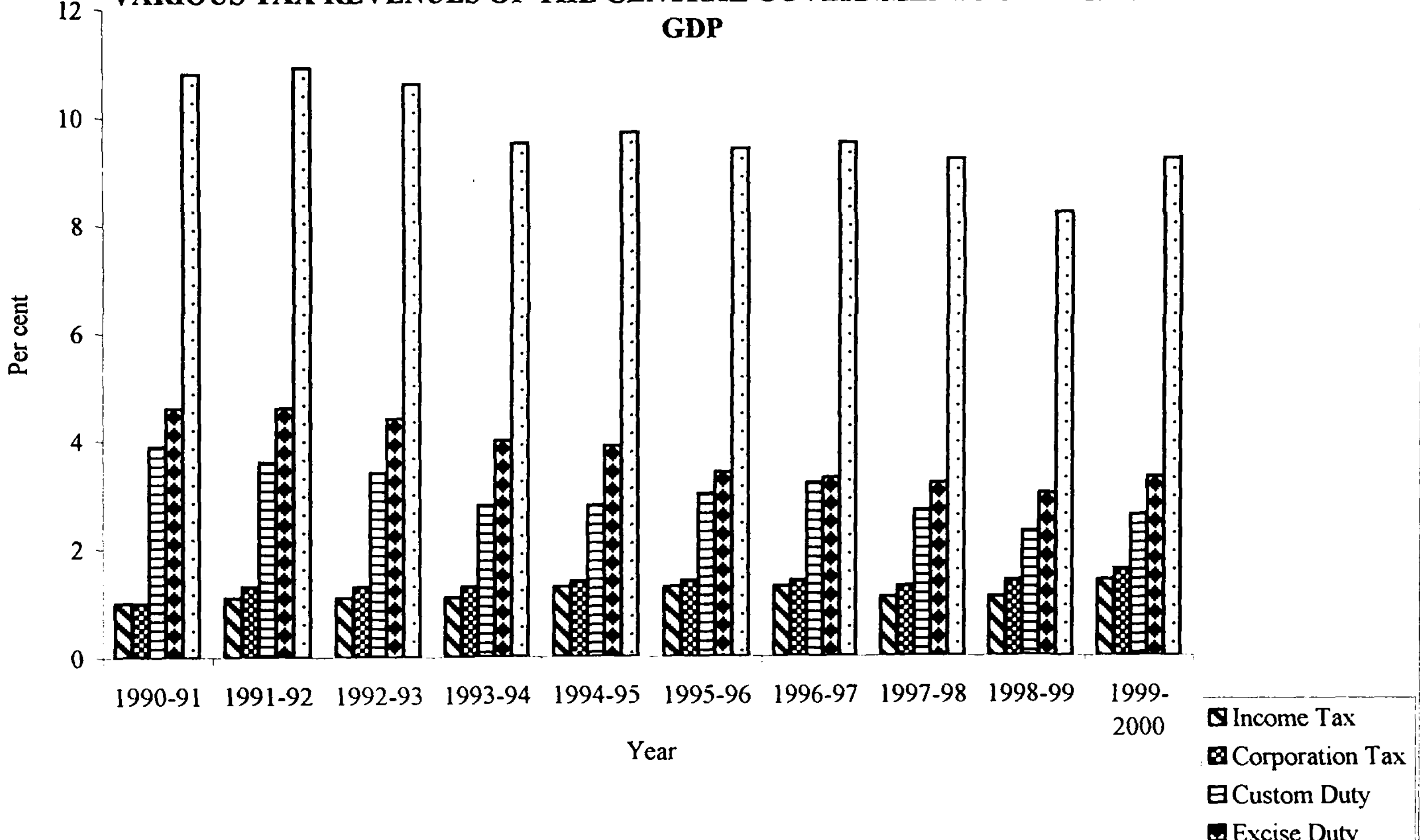
Year	Income Tax	Corporation Tax	Custom Duty	Union Excise Duty	Total Tax
1990-91	1.0	1.0	3.9	4.6	10.8
1991-92	1.1	1.3	3.6	4.6	10.9
1992-93	1.1	1.3	2.4	4.4	10.6
1993-94	1.1	1.3	2.8	4.0	9.5
1994-95	1.3	1.4	2.8	3.9	9.7
1995-96	1.3	1.4	3.0	3.4	9.4
1996-97	1.3	1.4	3.2	3.3	9.5
1997-98	1.1	1.3	2.7	3.2	9.2
1998-99	1.1	1.4	2.3	3.0	8.2
1999-2000	1.4	1.6	2.6	3.3	9.2

Note : Ratios to GDP at Current Market Prices for the period 1990-91 to 1994-95 use old series (base 1980-81) and from 1995-96 onwards use new series (base 1993-94) of National Accounts Statistics released by C.S.O.

Source : Government of India, Ministry of Finance, Economic Survey, 1996-97, 1999-2000.

FIGURE : c - i

VARIOUS TAX REVENUES OF THE CENTRAL GOVERNMENT AS PERCENTAGE OF GDP



Source : Government of India, Ministry of Finance, Economic Survey, 1996-97 & 1999-2000.

GDP goes, it can be seen from Table C-1 & Figure c-i that between 1990-91 and 1999-2000, when there were substantial tax rates reductions, the ratio of gross tax revenue to GDP declined from 10.8 to 9.2 per cent. Among different categories of taxes, customs and excise duty as a percentage of GDP declined sharply from 3.9 per cent to 2.6 per cent and from 4.6 per cent to 3.3 per cent respectively.

With regard to the direct taxes however, there was an improvement in terms of tax-GDP ratio. Between 1990-91 and 1999-2000 yield of personal income tax as a percentage of GDP increased from 1.0 per cent to 1.4 per cent; the corresponding increase for corporate tax was from 1.0 per cent; to 1.6 per cent. The point to be noted here is that even though the direct tax-GDP ratio increased in the post-reform period, it could not offset the loss in revenue due to the sharp reduction in customs and excise duty. Given the composition of the central tax revenue with around 65 per cent of the tax revenue coming from indirect taxes and only around 35 per cent coming form direct taxes (Table : C-5 & Figure c-viii) , this is not surprising. Thus when both direct and indirect tax rates were reduced, the fall in indirect tax revenues was bound to be more than the increase in direct tax revenues. This is the reason why even though the direct tax-GDP ratio increased during this period, growth in total tax revenue could not keep pace with the rate of growth of GDP.

5.2.3 Tax NAGDP Ratio

Since both direct as well as indirect taxes of the central government have mainly non-agricultural base, the ratio of central

TABLE : C-2
VARIOUS TAX REVENUES OF THE CENTRAL GOVERNMENT AS PERCENTAGE OF NON-AGRICULTURAL GDP (NAGDP) (1990-91 to 1999-2000)

Year	Income Tax	Corporation Tax	Custom Duty	Union Excise Duty	Total Tax
1990-91	1.63	1.62	6.26	7.43	17.46
1991-92	1.77	2.07	5.87	7.41	17.77
1992-93	1.82	2.05	5.47	7.10	17.18
1993-94	1.63	1.80	3.97	5.70	13.54
1994-95	1.82	2.10	4.07	5.67	14.01
1995-96	2.00	2.09	4.53	5.09	14.10
1996-97	2.02	2.06	4.74	5.00	14.25
1997-98	2.61	1.94	3.90	4.65	13.49
1998-99 (R.E.)	1.81	2.30	3.60	4.50	12.56

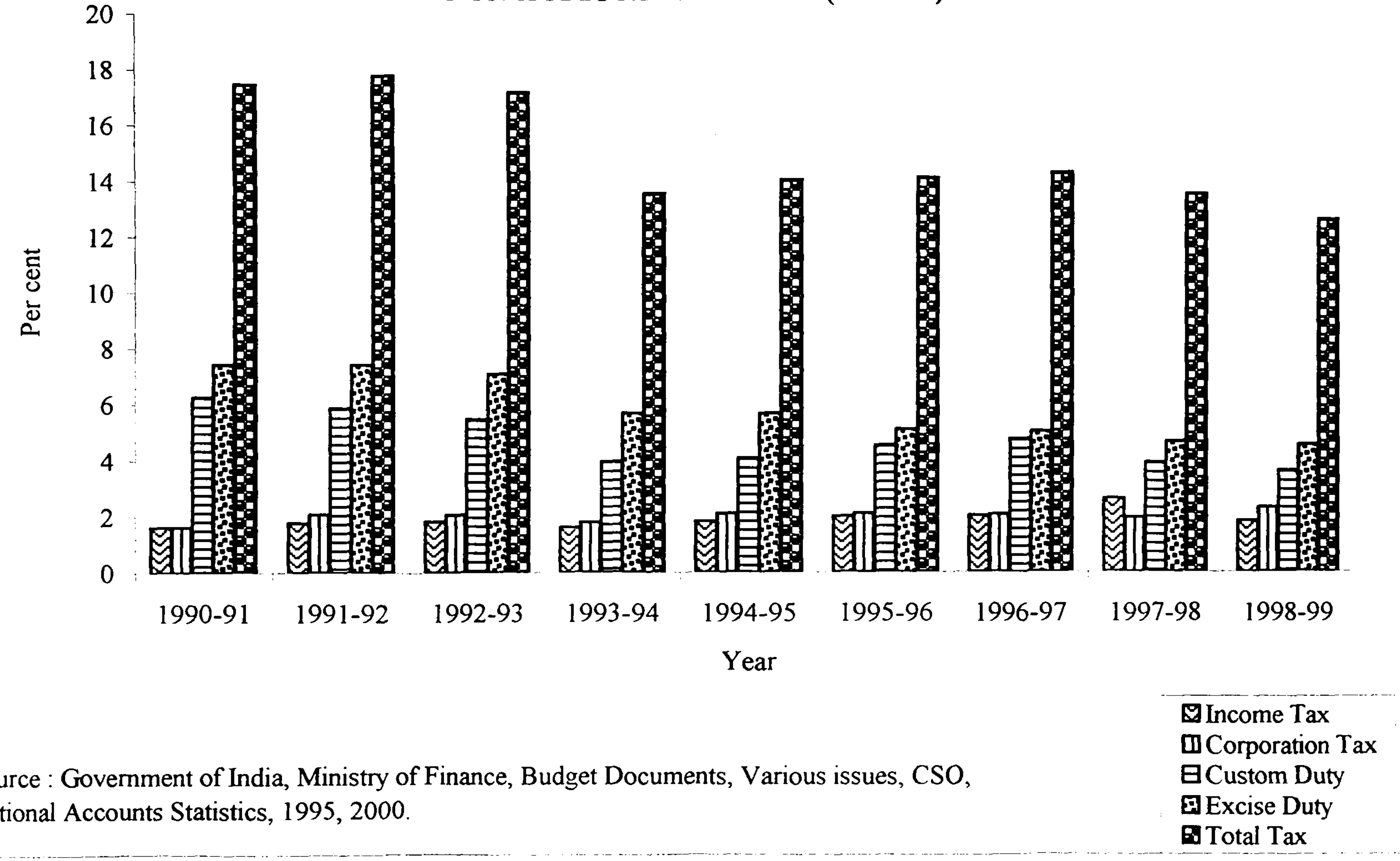
Note : R.E. (Revised Estimate)

Source : 1. Government of India, Ministry of Finance, Union Budget Documents, Various Issues.

2. C.S.O., National Accounts Statistics, 1995, 2000.

FIGURE : c - ii

VARIOUS TAX REVENUES OF THE CENTRAL GOVERNMENT AS PERCENTAGE OF NON-AGRICULTURAL GDP (NAGDP)



Source : Government of India, Ministry of Finance, Budget Documents, Various issues, CSO, National Accounts Statistics, 1995, 2000.

government tax revenues to NAGDP could be a better measure of tax buoyancy. Table C-2 and Figure c-ii presents the ratios of central tax revenues to NAGDP.

It is clear that there is no significant difference in the trends in ratios measured in terms of NAGDP or overall GDP. While for income tax, and corporate tax the ratios of revenues to NAGDP improved between 1990-91 and 1998-99, they declined for custom duty and excise duties. Likewise, the ratio for total tax revenue also declined during this period. The ratio of gross tax revenue to NAGDP declined from 17.46 per cent to 12.56 per cent during the period (Table-C-2). As can be seen from Table C-2 and Figure c-ii, ratios of custom duty and union excise duties to NAGDP declined sharply from 6.26 and 7.43 per cent to 3.60 and 4.50 per cent respectively. The ratio of direct taxes to NAGDP exhibited similar trend as with GDP. Ratio of income tax to NAGDP increased from 1.63 per cent in 1990-91 to 2.61 per cent in 1997-98, which marginally declined to 1.81 per cent in 1998-99. Similarly the ratio of corporation tax to NAGDP increased from 1.62 perc ent in 1990-91 to 2.30 per cent in 1998-99.

The rate of change of various ratios of central taxes to GDP and NAGDP is shown in Table C-3 and Figure c-iii. It can be seen that the rate of growth of these ratios with respect to both the bases have followed a similar pattern. Between 1991-92 and 1995-96, ratios of income tax revenue to GDP and NAGDP grew at a rate of 8.4 per cent and 4.72 percent per annum respectively the ratio of corporate tax revenue to NAGDP also increased at a rate lower (6.87 per cent) than the ratio of its

TABLE : C-3

COMPARISON OF SENSITIVITY OF TAX REVENUES WITH RESPECT TO GDP AND NAGDP DURING 1991-92 to 1998-99

(Percent)

Base :	GDP		NAGDP	
Period :	1991-92 to 1995-96	1996-97 to 1998-99	1991-92 to 1995-96	1996-97 to 1998-99
Income Tax	8.40	0.47	4.72	0.28
Croporation Tax	10.50	4.24	6.87	4.05
Custom Duty	-3.08	-7.70	-6.76	-7.88
Union Excise Duty	-4.98	-4.44	-8.66	-4.63
Total Tax	-1.18	-4.04	-4.86	-4.23

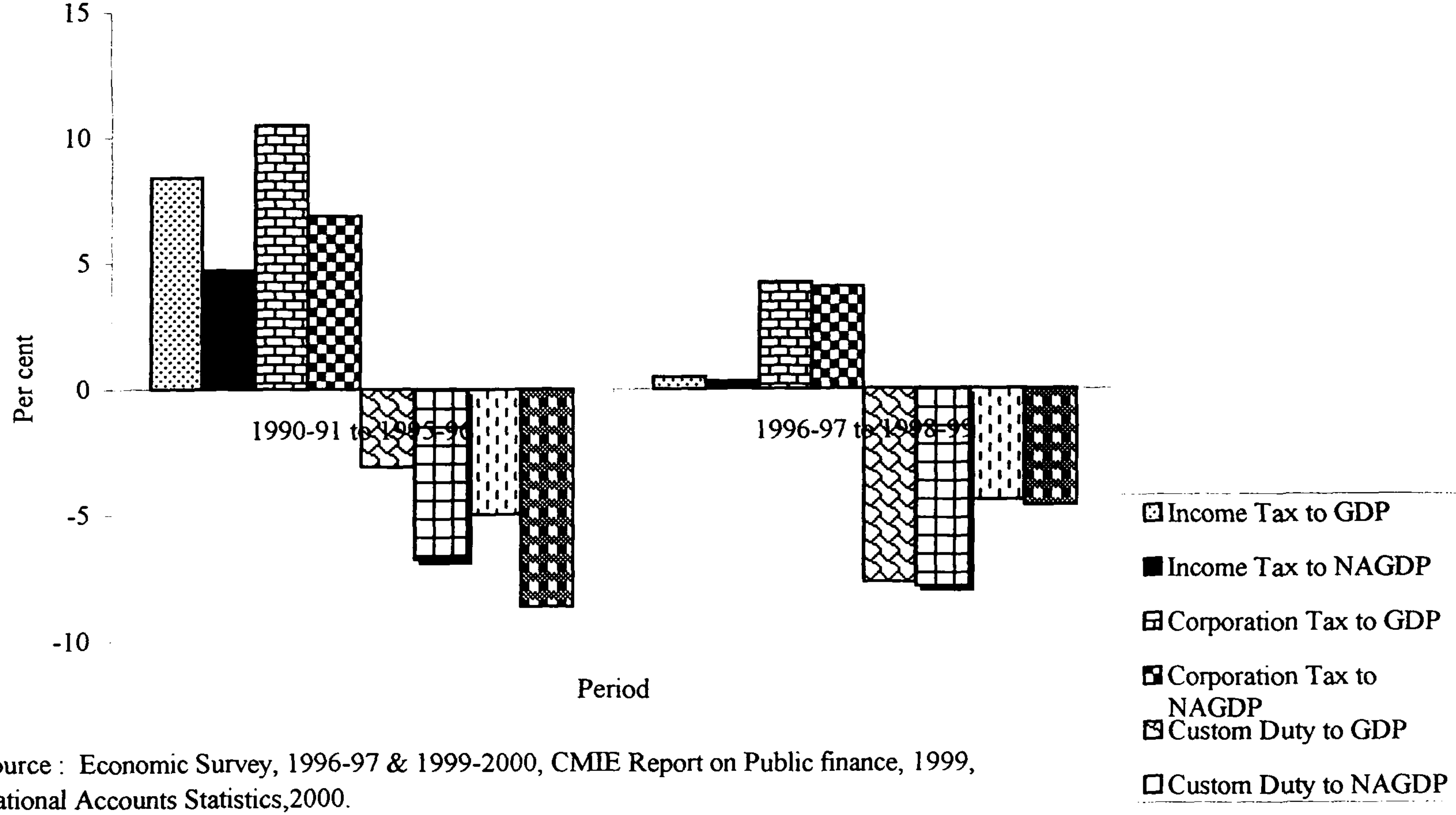
Note : These estimates are the annual average rate of change of various central government taxes with respect to GDP and NAGDP.

Source :

1. Government of India, Ministry of Finance, Economic survey, 1996-97 & 1999-2000.
2. CMIE, Report on Public Finance, 1999.
3. CSO, National Accounts Statistics, 2000.

FIGURE : c - iii

COMPARISON OF SENSITIVITY OF TAX REVENUES OF THE CENTRAL GOVERNMENT WITH RESPECT TO GDP AND NAGDP



Source : Economic Survey, 1996-97 & 1999-2000, CMIE Report on Public finance, 1999, National Accounts Statistics,2000.

revenue to GDP (10.50 per cent) during 1991-92 to 1995-96, which is contrary to what was expected. Since corporate tax is levied on non-agricultural profits of companies, the normal expectation is for the collection from this tax to be much more sensitive to changes in NAGDP. In the case of customs duty whose ratio with GDP as well as NAGDP declined at an annual average rate of around 3.0 per cent and 7.0 per cent respectively between 1991-92 and 1995-96. The ratio of excise revenue to GDP which declined at the annual rate of 5.0 percent during 1991-92 to 1995-96, on the other hand the ratio of excise revenue to NAGDP declined at the annual rate of 8.66 per cent during the period in reference. The ratio of the total tax revenue to GDP and NAGDP too declined at the rate of 1.18 and 4.86 per cent during 1991-92 to 1995-96.

Table C-3 & Figure c-iii showed slightly more grim picture in the second phase. Between 1996-97 to 1998-99, ratios of income tax to GDP and NAGDP grew at a rate of around 0.5 and 0.3 per cent respectively. This is crystal clear that the ratio of income tax revenue to GDP and NAGDP grew at a very low rate during second phase in comparison of first phase. The ratios of corporate tax to GDP and NAGDP grew at an annual rate of around 4.0 per cent during 1996-97 to 1998-99 which is well below than in the first phase. The ratio of custom and excise duties to GDP and NAGDP declined at the annual rates of 8.0 and 4.5 percent respectively between 1996-97 to 1998-99. As for as ratio of the total tax revenue to GDP and NAGDP is concerned during this period, the ratio to GDP declined at an average annual rate of 4.04 per cent which is higher than the previous period, as with NAGDP the rate of decline was slightly lower (-4.23 per cent) than the previous period (-4.86 per cent).

5.2.4 Problem of Time Lag

Now, we turn to the question of time lag posed in the beginning. For this purpose we have measured the income elasticity of individual taxes of the central government with respect to GDP for 1991-92 to 1998-99 and presented the result in Table C-4 and Figure c-iv. To start with income tax, it can be seen that income elasticity of income tax declined from 1.67 in 1991-92 to 1.19 in 1992-93. During this period, the rate of income tax declined form 50 per cent to 40 per cent, surcharge remaining constant at 12 per cent. Elasticity of income tax further declined to 1.06 in 1993-94, the year in which there was no change in the rate of tax and surcharge. In 1994-95, the elasticity of income tax increased to 1.79, the year in which surcharge on income tax was abolished. However, elasticity of income tax further increased to 1.95 in 1995-96, income tax rate and surcharge did not undergo any alteration from the previous year. In 1996-97, the elasticity of income tax declined to 1.11. Surprisingly in 1997-98, there was huge increase in the income elasticity of the income tax, to 4.23. Again, there was a dramatic fall in the income elasticity of the income tax in 1998-99, it declined to -1.25. For corporation tax, income elasticity of revenue declined from 3.11 in 1991-92 to 0.92 in 1992-93, with an increase in tax rate from 40 per cent to 45 pe rcent though corporate tax rate remained constant at 45 per cent till 1993-94, tax elasticity further declined to 0.89 but improved to 2.10 in 1994-95. In 1995-96 tax elasticity declined to 1.27. In 1996-97, with the reduction in surcharge from 15 per cent to 7.5 per cent and consequent reduction in effective rate of tax, income elasticity declined to 0.83 while in 1997-98, elasticity of tax further declined to 0.70 but it increased to

TABLE : C-4

INCOME ELASTICITY* OF DIFFERENT TAXES OF THE CENTRAL GOVERNMENT (1991-92 to 1998-99)

Year	Income Tax	Corporation Tax	Custom Duty	Union Excise Duty	Total Tax
1991-92	1.67	3.11	0.51	0.97	1.12
1992-93	1.19	0.92	0.47	0.67	0.75
1993-94	1.06	0.89	-0.46	0.20	0.10
1994-95	1.79	2.10	1.16	1.00	1.22
1995-96	1.95	1.27	2.20	0.50	1.35
1996-97	1.11	0.83	1.30	0.79	1.04
1997-98	4.23	0.70	-0.55	0.58	0.72
1998-99	-1.25	2.16	0.37	0.67	0.42
Average Elasticity					
1991-1992 to 1995-96	1.53	1.66	0.77	0.67	0.91
1996-97 to 1998-99	1.36	1.23	0.37	0.68	0.73

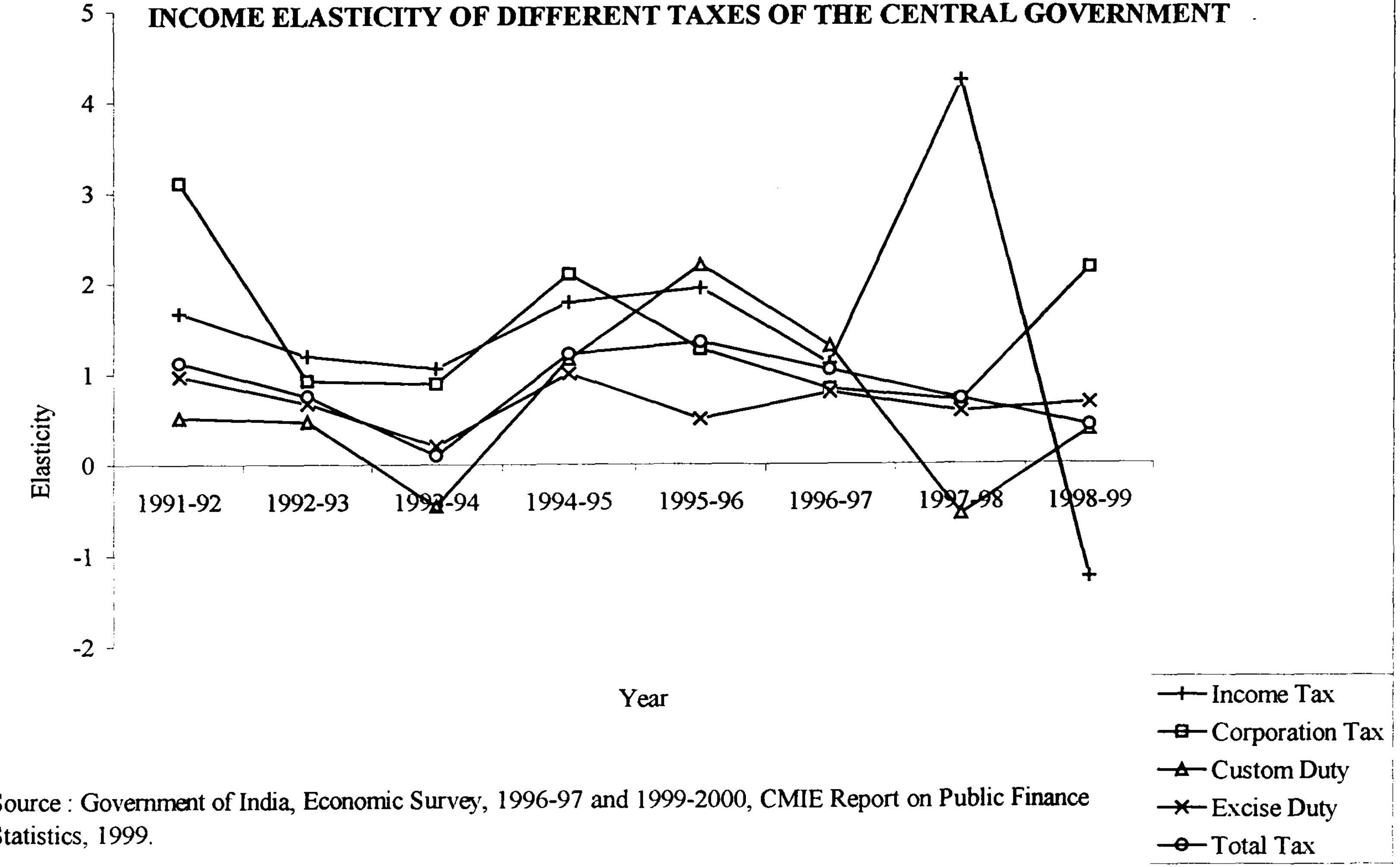
$$* \text{ Income Elasticity of Tax} = \frac{\text{Proportionate Change in Tax Yield}}{\text{Proportionate Change in GDP}}$$

Source : 1. Government of India, Ministry of Finance, Economic Survey, 1996- 97 & 1999-2000.

2. CMIE, Report on Public Finance, 1999.

FIGURE : c - iv

INCOME ELASTICITY OF DIFFERENT TAXES OF THE CENTRAL GOVERNMENT



Source : Government of India, Economic Survey, 1996-97 and 1999-2000, CMIE Report on Public Finance Statistics, 1999.

2.16 in 1998-99, perhaps this increase was due to reduction in the rate of corporation tax and abolition of surcharge in 1997-98.

The analysis of year to year movement of income tax rate and collections brings out that rate reduction in particular year did not result in an improvement in elasticity in that year itself. In fact, elasticity seems to decline with rate reduction. If the improvement in elasticity is due to the reduction in tax rate, it is registered only after a time lag of at least one year.

For both customs and excise, income elasticity during the first three years, from 1991-92 to 1993-94 was considerably below unity, for customs it was negative in 1993-94. The reduction in the peak customs duty during this period was from 150 per cent to 85 per cent. The peak rate was reduced further between 1994-95 and 1995-96 and was 50 per cent in 1995-96. The point to be noted here is that income elasticity of customs revenue increased to above unity in the period when the rate of reduction in duty was much lower. Between 1991-92 and 1993-94, the peak rate was reduced by 65 percentage points; between 1993-94 and 1995-96, the reduction was 35 percentage points. During 1996-97 when the peak rate of customs duty remained constant at 50 per cent; income elasticity of customs revenue was significantly above unity, though lower than in the immediately preceding year, 1995-96. This also reflects the operation of time-lag. In 1997-98, income elasticity of customs revenue declined to -0.55 but improve marginally in 1998-99 to 0.37.

As can be seen from Table C-4 and Figure c-iv, income elasticity of excise revenue was extremely low in 1993-94 and 1998-99 and below unity in four out of eight years, between 1991-92 and 1998-99. While income elasticity has fluctuated during the period for various major sources of central tax revenue, the least one can safely say on the basis of the experience of the recent past is that time lag does operate for both direct and indirect taxes.

The conclusion that emerges from the foregoing analysis is that compared to indirect taxes, direct taxes were more buoyant during the post-reform period. Share of direct taxes in total tax revenue also increased rapidly during this period. As can be seen from Table C-5 and Figure c-v share of direct taxes in the total tax revenue increased form 19.1 per cent in 1990-91 to 32.2 per cent in 1998-99 and was expected to grow 33.5 per cent in 1999-2000. On the other hand indirect taxes declined from 78.4 per cent in 1990-91 to 66.8 per cent in 1998-99, and was expected to decline further to 65.9 per cent in 1999-2000. Sharp decline in the buoyancy of indirect taxes was the reason why the rate of tax revenue fell well below the rate of growth of GDP during the period. The analysis of the movement of tax rates and income elasticities of various taxes showed that generally reduction in tax rate cannot make a tax more buoyant instantly. There is a time lag involved.

Regarding the declining share of indirect tax to GDP during this period, Rakesh Mohan (2000) rightly stated :

'the 1990s have witnessed a fall in the collection of indirect taxes when expressed as a proportion of GDP. With the opening up of the economy leading to large reductions in customs tariffs, revenue from custom duties was expected to decline and it will fall further in the years

TABLE : C-5

VARIOUS TAX REVENUES OF THE CENTRAL GOVERNMET AS PERCENTAGE OF GROSS TAX REVENUE (1990-91 to 1999-2000)

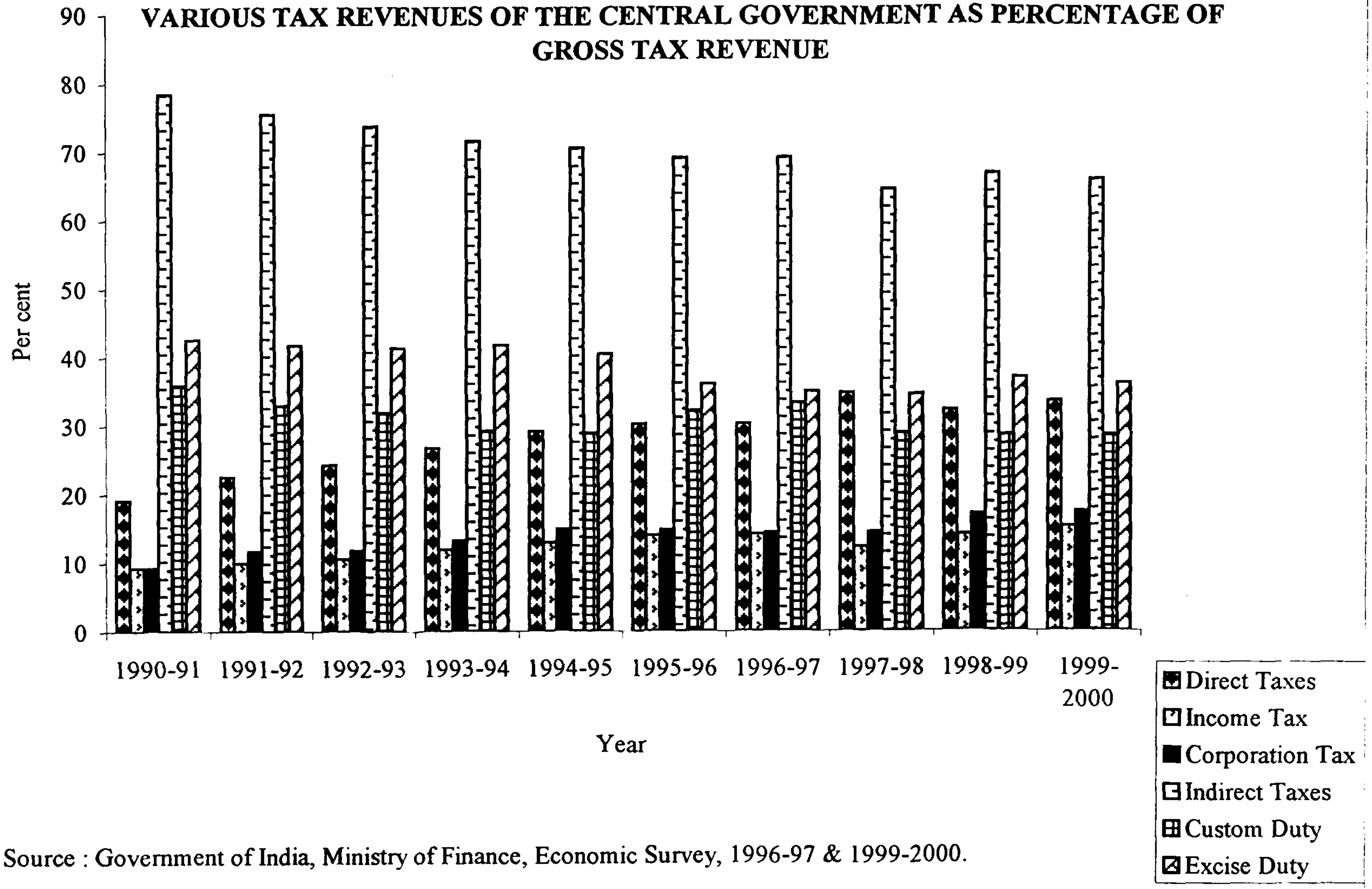
Year	Direct Tax (a)	Income Tax (i)	Corporate Tax (ii)	Indirect Tax (b)	Custom Duty (i)	union Excise Duty (ii)
1990-91	19.1	9.3	9.3	78.4	35.9	42.6
1991-92	22.6	10.0	11.7	75.5	33.0	41.7
1992-93	24.3	10.6	11.9	73.7	31.9	41.3
1993-94	26.8	12.0	13.3	71.6	29.3	41.8
1994-95	29.2	13.0	15.0	70.6	29.0	40.5
1995-96	30.2	14.0	14.8	69.1	32.1	36.1
1996-97	30.2	14.2	14.4	69.1	33.3	35.0
1997-98	34.7	12.3	14.4	64.5	28.9	34.5
1998-99 (R.E.)	32.2	14.0	17.0	66.8	28.6	36.9
1999-2000 (B.E.)	33.5	15.2	17.4	65.9	28.5	36.1

Note : R.E. (Revised Estimate), B.E. (Budget Estimate)

Source : Government of India, Ministry of Finance, Economic Survey, 1996-97, 1999-2000.

FIGURE : c - v

VARIOUS TAX REVENUES OF THE CENTRAL GOVERNMENT AS PERCENTAGE OF GROSS TAX REVENUE



Source : Government of India, Ministry of Finance, Economic Survey, 1996-97 & 1999-2000.

to come as these tariffs are brought down further. Buoyancy in indirect taxes can therefore only be achieved through increase in excise tax collections at the central level. The structural problem that exists in this regard is the constitutional provision which assigns excise tax to the central government and sales tax to state governments. As the share of agriculture falls with the overall development there should be an increase in revenue since agriculture is largely untaxed. Correspondingly, the share of the secondary and services sector increased. The long term scenario is that the share of agriculture will continue to fall and that of services in particular will continue to rise. Hence for tax revenues to increase as a share of GDP the imposition of indirect taxes on the service sector is imperative. This can essentially be achieved by the imposition of a widespread value added tax on all sectors of the economy. Levying such a tax will require an amendment to the constitution alongwith the achievement of consensus with the states so that it becomes feasible to do so. Thus long-term buoyancy in indirect tax revenues can be achieved only if this major structural change can be brought about'.[2]

5.2.5 Non-Tax Revenue

The main area of controversy among non-tax revenue soruces is public sector units (PSUs). It is generally accepted that the government should discontinue operations in activities which can be equally or better provided by the private sector. The performance of PSUs has taken on added interest in this context and the privatisation of selected PSUs has become a reality. The state electricity boards, transport enterprises and other departmental undertakings, which have had

TABLE : C-6

PROFILE OF NON-TAX REVENUE OF THE CENTRAL GOVERNMENT (1990-91 to 1999-2000)

Year	Non-Tax Revenue (Percentage Change)	Non-Tax Revenue (As per cent of GDP)	Non-Tax Revenue (As per cent of Total Revenue)
1990-91	-14.13	2.24	21.77
1991-92	33.27	2.59	24.14
1992-93	25.83	2.85	27.07
1993-94	9.56	2.75	29.14
1994-95	7.40	2.50	25.94
1995-96	19.31	2.57	25.60
1996-97	15.56	2.58	25.80
1997-98	17.35	2.70	28.55
1998-99 (R.E.)	25.90	2.96	30.53
1999-2000 (B.E.)	4.90	2.80	28.00
1990-91 to 1994-95 (Avg.)	12.40	2.57	25.63
1995-96 to 1999-2000 (Avg.)	16.60	2.68	27.62

Note : B.E. (Budget Estimate), RE (Revised Estimate), (Average).

Source : Government of India, Ministry of Finance, Budget Documents, Various Issues.

historically low returns, as well as irrigation and other utility rates which have not reflected costs of production by any imagination have come under scrutiny. Overall share of non-tax revenues has remained stagnant between 2.6 per cent and 2.7 per cent as a proportion of GDP during 1990 to 1999. Thus,we can say higher investment has not provided higher returns.

As it is evident from Table C-6 that there has been some improvement in non-tax revenue collections from 2.24 per cent as a ratio to GDP in 1990-91 to 2.96 per cent in 1998-99 and budgeted to slighty decline to 2.80 per cent in 1990-2000. As a share of total revenue receipts non-tax revenue collections increased from 21.77 per cent in 1990-91 to 30.53 per cent in 1998-99, and was expected to slightly decline to 28 per cent in 1999-2000. As far as percentage change in non-tax revenue over the previous year is concerned, it is evident from Table C-6 that during the first five years of stabilization period, the average annual rate was 12.40 per cent, which rose to 16.60 per cent during 1995-96 to 1999-2000. These trends clearly indicate the positive responsiveness of the non-tax revenues to the fiscal stabilization steps. Though overall performance of the non-tax revenue is still far from satisfactory.

5.3 EFFECT OF EXPENDITURE COMPRESSION

As it has been argued earlier that the main culprit behind the fiscal instability in Indian economy is ever-rising public expenditure. Similar sentiment has been also expressed by Parthasarthi Shome (1997) :

'in recent Indian history, government expenditure was put on a high altar. That India had one of the highest incremental capital-output ratios in its public sector was widely judged to be proof of the efficacy of the plan process. It has taken virtually five decades to make a visible dent in that economic philosophy, mainly as a result of the low productivity of public investment. Multiple objectives interfere with public enterprise decision-making, rendering it almost impossible for them to operate efficiently. The need for ever higher public investment has resulted in high priority being placed on the need to generate ever higher savings rates with little concern over the quality of use of those savings'.[3]

The 1991 economic crisis brought to sharper focus issues such as the role of the government and trends in its expenditure. In the 1990s the central government did pass on some current expenditure, mainly in the social sector, to the states. This reduced central government expenditure as a ratio to GDP during the post-reform period. Despite the reductions in the expenditure/GDP ratio, the central government recently recognized existing problems in expenditure control and management.

5.3.1 Expenditure Trends in Stabilization Period

In order to understand the current fiscal predicament of the central government it is necessary to examine the pattern of central government expenditure. As already mentioned above, the key threat to fiscal stabilization is the substantial decline in investment expenditures made by the government and fast growing non-plan expenditures.

Here, we have tried to analyse the trends in expenditure of the central government in the post-reform period. The total expenditure of the central government during 1985-86 to 1990-91 was hovered around 20 per cent of GDP and has then declined to around 18 per cent during

TABLE : C-7

PROFILE OF EXPENDITURE OF THE CENTRAL GOVERNMENT (Per cent of GDP) (1990-91 to 1999-2000)

Year	Non-Plan Expenditure	Interest Payments	Defence Expenditure	Subsidies	Other Non-Plan Expenditure	Plan Expenditure	Total Expenditure
1990-91	14.37	4.01	2.88	2.27	5.20	5.30	19.66
1991-92	13.04	4.31	2.65	1.99	4.09	5.02	18.06
1992-93	12.19	4.41	2.49	1.70	3.59	5.20	17.38
1993-94	12.26	4.59	2.73	1.58	3.36	5.45	17.71
1994-95	11.99	4.66	2.46	1.37	3.50	5.01	17.00
1995-96	12.40	4.57	2.45	1.21	3.81	4.23	16.25
1996-97	11.70	4.63	2.34	1.32	3.38	4.35	16.02
1997-98	12.22	4.64	2.49	1.38	3.74	4.17	16.39
1998-99 (R.E.)	13.14	4.75	2.53	1.52	4.34	4.21	17.34
1999-2000 (B.E.)	11.46	4.87	2.53	1.32	2.74	4.26	15.73
1990-91 to 1994-95 (Avg.)	12.77	4.40	2.64	1.78	3.95	5.20	17.96
1995-96 to 1999-2000 (Avg.)	12.18	4.70	2.47	1.35	3.60	4.24	16.35

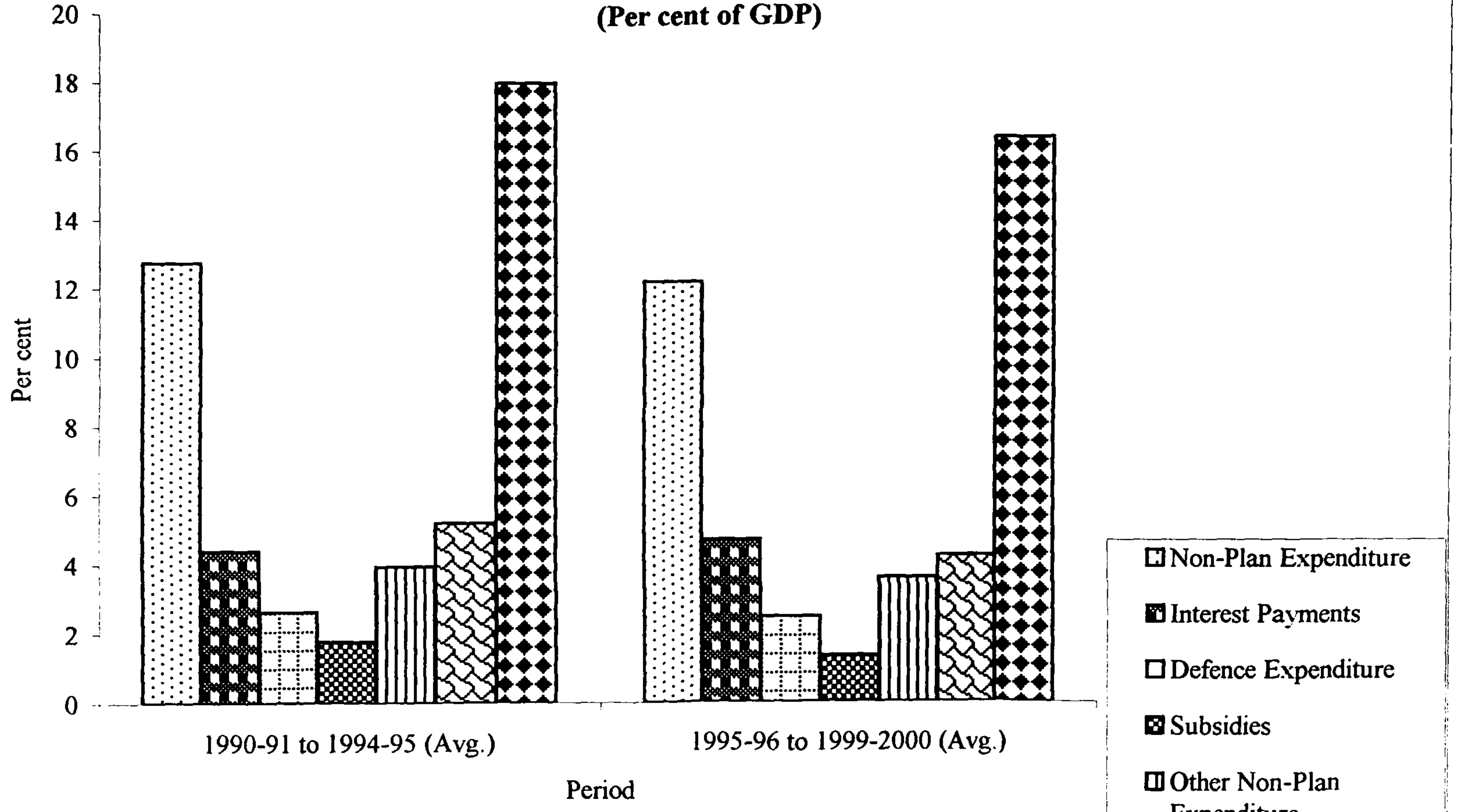
Note : B.E. (Budget Estimate), R.E. (Revised Estimate), Avg. (Average).

Source : Government of India, Ministry of Finance, Budget Documents, Various Issues ,Economic Survey, 2000-2001.

FIGURE : c - vi

PROFILE OF EXPENDITURE OF THE CENTRAL GOVERNMENT

(Per cent of GDP)



Source : Government of India, Ministry of Finance, Buduget Documents, Economic Survey, Various Issues.

1990-91 to 1994-95 and further declined to 16.35 per cent during 1995-96 to 1999-2000 (Table C-7 and Figure c-vi). At the same time non plan expenditure has increased from 12.50 per cent to GDP in 1985-86 to 14.37 per cent in 1990-91 and then marginally declined to 12.77 per cent during 1990-91 to 1994-95 and has further declined to 12.18 per cent between 1995-96 to 1999-2000. This decline in non-plan expenditures was due to decline in defence expenditure, subsidies (including food and fertilizer) and other non-plan expenditures. At the same time the most improtant item of non-plan expenditures i.e. interest payments increased during the post-reform period. even after ten years of the introduction of fiscal stabilization measures, interest payments are posing threat to fiscal stability. As it is clear from Table C-7 and Figure C-vi that interest payments increased from 4.01 per cent to GDP in 1990-91 to 4.87 per cent in 1999-2000. During the first five years of stabilization period, interest payments as a ratio to GDP were 4.40 per cent which rose to 4.70 per cent during the 1995-96 to 1999-2000. On the other hand Defence expenditure, subsidies and other non-plan expenditure demonstrated a declining trend from 2.64, 1.78 and 3.95 per cent respectively during the first phase (1990-91 to 1994-95) to 2.47, 1.35 and 3.60 per cent respectively during the second period in reference. Plan expenditures were kept high at about 6.0 per cent to 7.00 per cent of GDP throughout the 1980s. Correspondingly, capital expenditures of central government were sustained at levels of 6.00 per cent to 7.00 per cent of GDP during the same period. Now, both plan expenditures and capital expenditures of the central government have fallen to levels of about 4.00 per cent of GDP or less.

TABLE : C-8

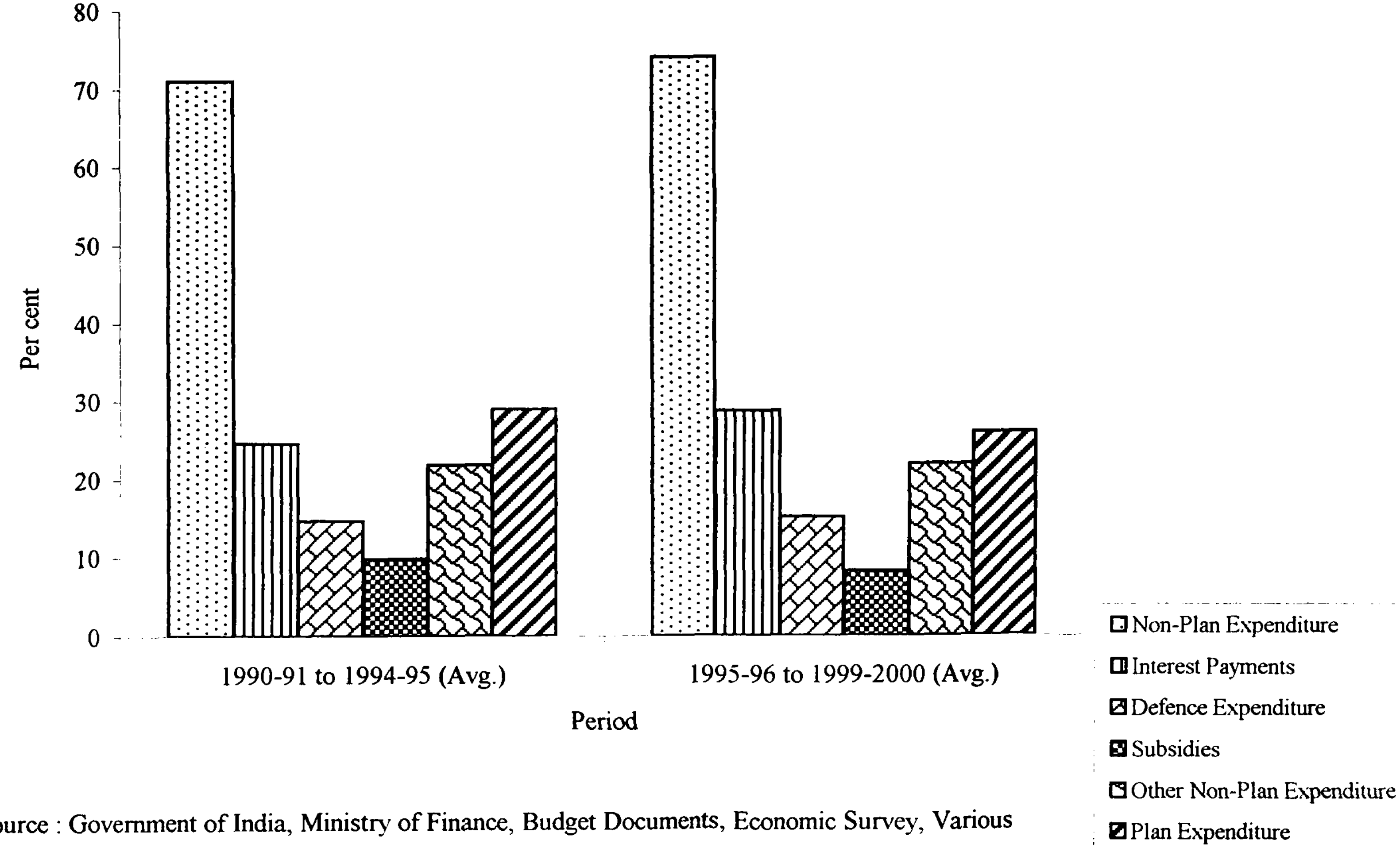
COMPOSITION OF EXPENDITURE OF THE CENTRAL GOVERNMENT (Per cent of Total Expenditure) (1990-91 to 1999-2000)

Year	Non-Plan Expenditure	Interest Payments	Defence Expenditure	Subsidies	Other Non-Plan Expenditure	Plan Expenditure	Total Expenditure
1990-91	73.06	20.41	14.65	11.55	26.45	26.94	100.00
1991-92	72.20	23.87	14.67	11.00	22.67	27.80	100.00
1992-93	70.10	25.34	14.34	9.78	20.64	29.90	100.00
1993-94	69.22	25.90	15.40	8.94	19.00	30.78	100.00
1994-95	70.52	27.41	14.46	8.05	20.61	29.48	100.00
1995-96	73.99	28.06	15.06	7.46	23.40	26.01	100.00
1996-97	72.86	28.92	14.58	8.25	21.11	27.14	100.00
1997-98	74.54	28.28	15.20	8.40	22.66	25.46	100.00
1998-99 (R.E.)	75.75	27.40	14.61	8.76	25.00	24.25	100.00
1999-2000 (B.E.)	72.89	30.99	16.09	8.39	17.42	27.11	100.00
1990-91 to 1994-95 (Avg.)	71.02	24.59	14.70	9.86	21.87	28.98	100.00
1995-96 to 1999-2000 (Avg.)	74.01	28.73	15.12	8.25	21.92	25.99	100.00

Note : R.E. (Revised Estimate), B.E. (Budget Estimate), Avg. (Average).

Source : Government of India, Ministry of Finance, Budget Documents, Various Issues, Economic Survey, 2000-2001.

FIGURE : c-vii
COMPOSITION OF EXPENDITURE OF THE CENTRAL GOVERNMENT
(Per cent of Total Expenditure)



Source : Government of India, Ministry of Finance, Budget Documents, Economic Survey, Various Issues.

The non-sustainability of fiscal expansion is demonstrated by the sustained increase in interest payments. Interest payments now constitute the largest component of expenditure of the central government. At present it is around 31.00 per cent of the total expenditure as against around 20.00 per cent in 1990-91 (Table C-8 and Figure c-vii). Looking specifically at current expenditures, the lack of success with expenditure reduction becomes clear. There has been a steady increase in interest payments. It is clear that the compensation has come not only from decreases in other components of current expenditure such as subsidies, defence and general administration (including wages and salaries) but also capital and plan expenditures. The fifth pay commission is currently regarded as the villain of the piece in causing the current fiscal problems. Analysis of the data as documented here suggests that this is not the case at the central government level. The total cost of government salaries excluding defence and police (roughly corresponding to the item 'other non-plan expenditure') when expressed as a proportion of GDP, can be seen to be much lower now than it was throughout the 1980s. In other words, non-plan expenditure on government salaries and wages has not increased as fast as GDP over this period. Interest payments are now at least three times that of the non-plan government expenditure excluding the military and police. The key area for action in correcting this fiscal imbalance is related to rising debt servicing obligations of the central government.

The analysis of government expenditure trends in per capita terms (at current prices) also bring out the similar result. These trends

TABLE : C-9

PER CAPITA CENTRAL GOVERNMENT EXPENDITURE (at current prices in rupees)

(1990-91 to 1999-2000)

Year	Non-Plan Expenditure	Interest Payments	Defence Expenditure	Subsidies	Other Non-Plan Expenditure	Plan Expenditure	Total Expenditure
1990-91	917.00	256.20	184.00	145.00	332.00	338.10	1255.04
1991-92	940.00	310.70	191.00	143.14	295.06	361.70	1301.60
1992-93	985.76	356.36	201.63	137.56	290.21	420.41	1406.20
1993-94	1102.03	412.36	245.17	142.33	302.17	490.03	1592.10
1994-95	1248.50	485.24	256.00	142.42	364.80	521.78	1770.25
1995-96	1423.00	539.71	289.71	143.53	450.00	500.26	1923.14
1996-97	1563.14	620.36	312.81	177.03	453.00	582.12	2145.26
1997-98	1930.85	732.55	393.73	217.60	587.00	659.50	2590.35
1998-99 (R.E.)	2374.56	859.00	458.00	274.60	783.70	760.20	3134.73
1999-2000 (B.E.)	2238.73	951.82	494.20	257.70	535.03	832.65	3071.40
1990-91 to 1994-95 (Avg.)	1038.66	364.17	215.60	142.10	316.85	426.40	1465.04
1995-96 to 1999-2000 (Avg.)	1906.06	740.70	389.70	214.10	561.75	667.00	2573.00

Note : R.E. (Revised Estimate), B.E. (Budget Estimate), Avg. (Average).

Source : Government of India, Ministry of Finance, Budget Documents, Various Issues, Economic Survey, 2000-2001.

are shown in Table C-9. During the entire period of ten years of stabilization (i.e. 1990-91 to 1999-2000) total expenditure of the central government in per capita terms increased from Rs. 1255.04 in 1990-91 to Rs. 3071.40 in 1999-2000. In the first five years of the period in reference, the average per capita total expenditure was Rs. 1465 which rose sharply to Rs. 2573 in the next period. Non-plan expenditure contributed very much to this increase. During 1990-91 to 1999-2000, per capita non-plan expenditure increased more than two times, i.e. from Rs. 917 to Rs. 2238.73. As described earlier, interest payments increased more than three times during the period in reference. On the other hand rising trend of per capita plan and capital expenditure was not as sharp as non-plan expenditure.

Another analysis has been carried out with reference to the fiscal stabilization programme in India. Table C-10 and Figure c-viii present overall impact of expenditure management and control on the real growth of expenditure of the central government. It has to be said that in the first five years of the post economic reform period (since 1991-92), while almost all non-interest items of public expenditure have been reduced in real terms. During 1991-92 to 1995-96 average annual growth of total expenditure in real terms was only 1.00 per cent. During the same period non-plan expenditure grew negatively by -1.41 per cent, irrespective of the fact that interest payments grew at a rate of 3.60 per cent, but this was compensated by huge reduction in subsidies (-8.31 per cent). Simultaneously, capital expenditure also declines rapidly during the period in reference, its real average annual growth rate was -8.26 per cent. This means that during the first five years of the fiscal

TABLE : C-10

EXPENDITURE OF THE CENTRAL GOVERNMENT IN STABILIZATION PERIOD (1990-91 to 1999-2000)

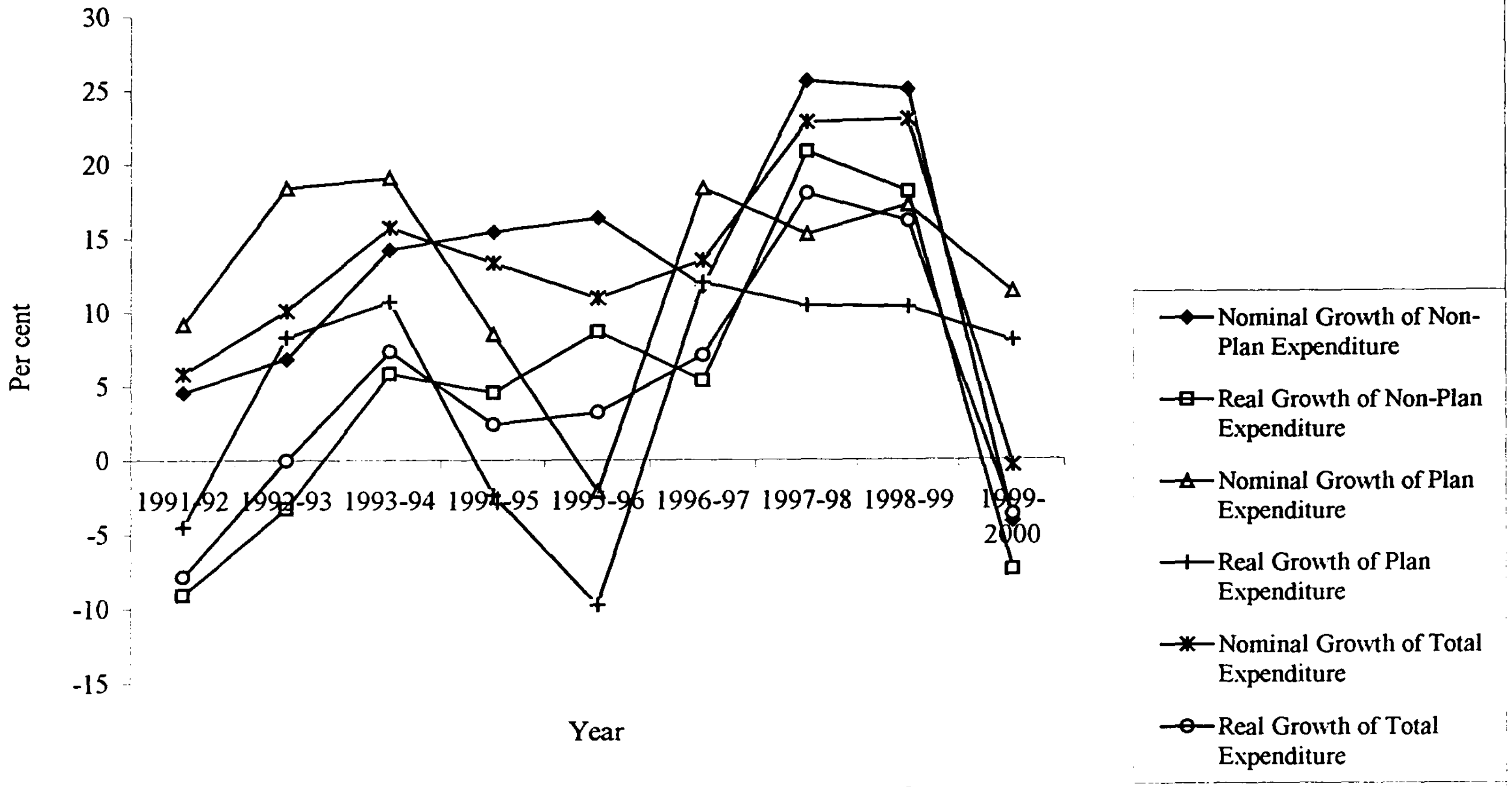
(Average Annual Growth Rate : Nominal & Real) (Per cent)

Year	Non-Plan Expenditure	Interest Payments	Defence Expenditure	Subsidies	Other Non-Plan Expenditure	Plan-Expenditure	Total Expenditure (Plan + Non-Plan)	Average Inflation Rate (52 Week Average
1991-92	4.57	0.24	0.06	0.78	-9.31	9.15	5.81	13.7
	(-9.13)	(-13.46)	(-13.64)	(-12.92)	(-23.01)	(-4.55)	(-7.89)	
1992-93	6.84	16.84	7.55	-2.11	0.19	18.41	10.06	10.1
	(-3.26)	(6.74)	(-2.55)	(-12.21)	(-9.91)	(8.31)	(-0.04)	
1993-94	14.23	18.23	24.25	5.73	6.39	19.10	15.70	8.4
	(5.83)	(9.83)	(15.85)	(-2.67)	(-2.01)	(10.70)	(7.30)	
1994-95	15.45	19.92	6.41	1.97	23.03	8.51	13.31	10.9
	(4.55)	(9.02)	(-4.49)	(-8.93)	(12.13)	(-2.39)	(2.41)	
1995-96	16.35	13.55	15.53	2.88	25.92	-2.12	10.91	7.7
	(8.65)	(5.85)	(7.83)	(-4.82)	(18.22)	(-9.82)	(3.21)	
1996-97	11.75	16.93	9.84	25.47	2.40	18.37	13.47	6.4
	(5.35)	(10.53)	(3.44)	(19.07)	(-4.00)	(11.97)	(7.07)	
1997-98	25.62	20.10	28.00	25.00	31.80	15.21	22.80	4.8
	(20.82)	(15.30)	(23.20)	(20.20)	(27.00)	(10.41)	(18.00)	
1998-99	25.03	19.21	18.26	28.31	35.74	17.20	23.03	6.9
	(18.13)	(12.31)	(11.36)	(21.41)	(28.84)	(10.30)	(16.13)	
1999-2000	-4.17	12.63	9.67	-4.62	-30.61	11.33	-0.41	3.3
	(-7.47)	(9.33)	(6.37)	(-7.92)	(-33.91)	(8.03)	(-3.71)	
1991-92 to	8.75	13.76	10.76	1.85	9.24	10.61	11.16	10.16
1995-96(Avg.)	(-1.41)	(3.60)	(0.60)	(-8.31)	(-0.92)	(0.45)	(1.00)	
1996-97 to	14.56	17.22	16.44	18.54	9.85	15.53	14.72	5.35
1999-2000(Avg.)	(9.21)	(11.09)	(13.19)	(4.49)	(10.18)	(9.37)		

Note : Figures within brackets are real average annual growth rate.

Source : Government of India, Ministry of Finance, Budget Documents, various Issues, Economic Survey, 2000-2001.

FIGURE : c - viii
GROWTH OF EXPENDITURE OF THE CENTRAL GOVERNMENT IN STABILIZATION PERIOD (Nominal and Real)



Source : Government of India, Ministry of Finance, Budget Documents, Economic Survery , Various Issues.

stabilization period, the main burden of expenditure compression in the fiscal adjustment has so far fallen on the redistributive package and items of capital expenditure. And this is not a good sign. As emphasised by S. Mundle, and M. Hiranaya (1993) that :

'The crowding out of public expenditure on the anti-poverty programmes, human resource development and capital formation must be viewed with concern because it is not just a temporary aberration but a continuation of a secular tendency which has been accentuated instead of being reversed in the current adjustment programme. India's poor record in the development of human capabilities and the construction and maintenance of essential infrastructure are as much a cause for India's poor international competitiveness as the over regulated and over protectionist policy regime. Continuing neglect of these areas of public action will compromise the long-term growth prospects of the economy apart from their negative impact on current welfare'.[4]

On the other hand during 1996-97 to 1999-2000 real average annual growth rates of all the items of expenditure of the central government were positive. The disheartening feature of this analysis is that during this period growth rate of subsidies surpassed even that of interest rates. However, to some extent due to lower inflation rate in the second phase, there was a sharp increase in the real growth of all the components of expenditure as compared to first phase. This is very much evident in the case of nominal growth of expenditure. The gap in the nominal growth rates of all the components of expenditure between the two periods mentioned above is not as much wider as in case of real growth rate. Thus, it is clear that during the post-reform period (since 1991) public expenditure on almost all the items except interest payments have been cut in real terms. However the sharpest cuts have fallen on precisely those items of expenditure which ought to be protected, i.e., capital expenditure, human resource development and the redistributive package. Hopefully the next round of budgets at the centre will attempt to reverse this trend.

5.3.2. Quality of Expenditure

The quality of public expenditure also indirectly affects the quantity. Take poverty alleviation, anti-poverty programmes that are geared towards rural welfare, such as the Integrated Rural Development Programme (IRDP) or the National Rural Employment Programme (NREP), later renamed Jawahar Rozgar Yojna, have tended to lack funds, are spread rather thinly and are subject to leakage. Even the mid day meal programme that was announced in August 1995 and annually cost almost 1/2 per cent of GDP has had its scope truncated as indicated above, mainly because of implementation problems.[ii]

The incidence of politically motivated social programmes seems to have increased so much that unusual measures are now needed to control them. All redistribution policies and programmes should be formed as a package, with a clear beginning and a fixed termination. The party or parties in question that comprise the government of the day should be made legally responsible for a full explanation of the financing of such programmes rather than just receiving accolades for the mere announcement of largesee. Such programmes may be founded only with identifiable sources of funds.

Another area of declared preoccupation of the government is education. It has been discussed and declared as a fundamental right. There seems to be general agreement on the efficacy of expenditure on education. Another area worth mentioning is health. While public expenditure on primary health has been quite important, its objective has become intertwined with others such as population control which should be targeted independently. Even as the nation's population soars in the absence of a credible population policy, the exigencies of population growth have forced a switch in emphasis from primary health to population in many instances, rendering the provision of primary health care insufficient or less than intended while the size of the population tends to explode.[iii] Prima facie it would seem that neither primary health care nor population control is adequately served under the prevailing arrangements. Other examples may also be provided to indicate the questionability in the nature and quality of expenditures.

This discussion should point towards the need for putting in place appropriate mechanisms for honest adminsitration and implementation rather than quantitative increases in expenditure size that could safeguard the quality of such expenditures and check leakages more meaningfully than what continually emerging revelations regarding implementation in many states seems to indicate. While the increases in social expenditures in recent budgets may be well intentioned, such programmes should be increasingly tested on their end result after implementation, rather than on the announcement effect before it.

5.4 PERFORMANCE OF CENTRAL PUBLIC SECTOR UNDERTAKINGS DURING STABILIZATION PERIOD

Jawaharlal Nehru's idea of the public sector was very different from the way it has evolved through the years. Nehru's conception for the public sector was for attaining the commanding heights of the economy and not its money demanding depths. Private sector enterprises were then seen to be inefficient and public sector enterprises were expected to induce a greater degree of efficiency in the economy. The assumption was that efficient public sector would be instrumental in the generation of large surpluses. The record has been the opposite. The original case for heavy reliance on public sector enterprises was spelt out in the Industrial Policy Resolution of 1956. The Resolution stated :

'the adoption of the socialist pattern of society as the national objective as well as the need for planned and rapid development, require that all industries of basic and strategic importance or the nature of public utility services, should be in the public sector. The state has therefore to assume direct responsibility for the future development of industries over a wider area'.[5]

However, we must recognise that public sector enterprises do dominate key sectors of the economy in the infrastructure and heavy industry areas. It is all the more necessary for the economy that these enterprises become more efficient.

5.4.1 Trends

From the late 1980s, the public sector began suffering from financial problems, stemming almost exclusively from a steady decline in budgetary support. In 1985-86, budgetary resources were being provided to public enterprises to meet almost 50 per cent of their investment requirements. This share had fallen to less than 20 per cent by the mid-1990s. Correspondingly, internal and extra-budgetary resources have increased from about 50 per cent to over 80 per cent to total investment. The share of direct borrowing within that increased from about 15 per cent to about 25 per cent. Above description illustrate the impact of the deteriorating fiscal situation the resources requirement of public sector enterprises. The government simply cannot afford to play an active role as an owner in sustaining these enterprises in the industrial sector in future without being extremely selective. The increasing exposure of the public sector enterprises to both domestic and external debt may also lead to problems of sickness in the future. If the government as the owner can no longer supply adequate volumes of equity in support of the financial requirements for new investment, there is little alternative to the sharing of equity outside the government.

Bimal Jalan also expressed similar views, 'The most conspicuous failure of public sector enterprises has been in the financial area. An important shortcoming has been the relatively low level of capacity utilization in many enterprises. This has increased the capital output ratio, and reduced efficiency in the use of capital. The poor financial performance of several enterprises is traceable to a large extent to poor investment decisions. These are reflected in factors such as inappropriate location, inappropriate technology, an irrational product mix, and imposed marketing arrangements'.[6]

TABLE : C-11

PROFITABILITY OF CENTRAL PUBLIC SECTOR UNDERTAKINGS
(1991-92 to 1998-99)

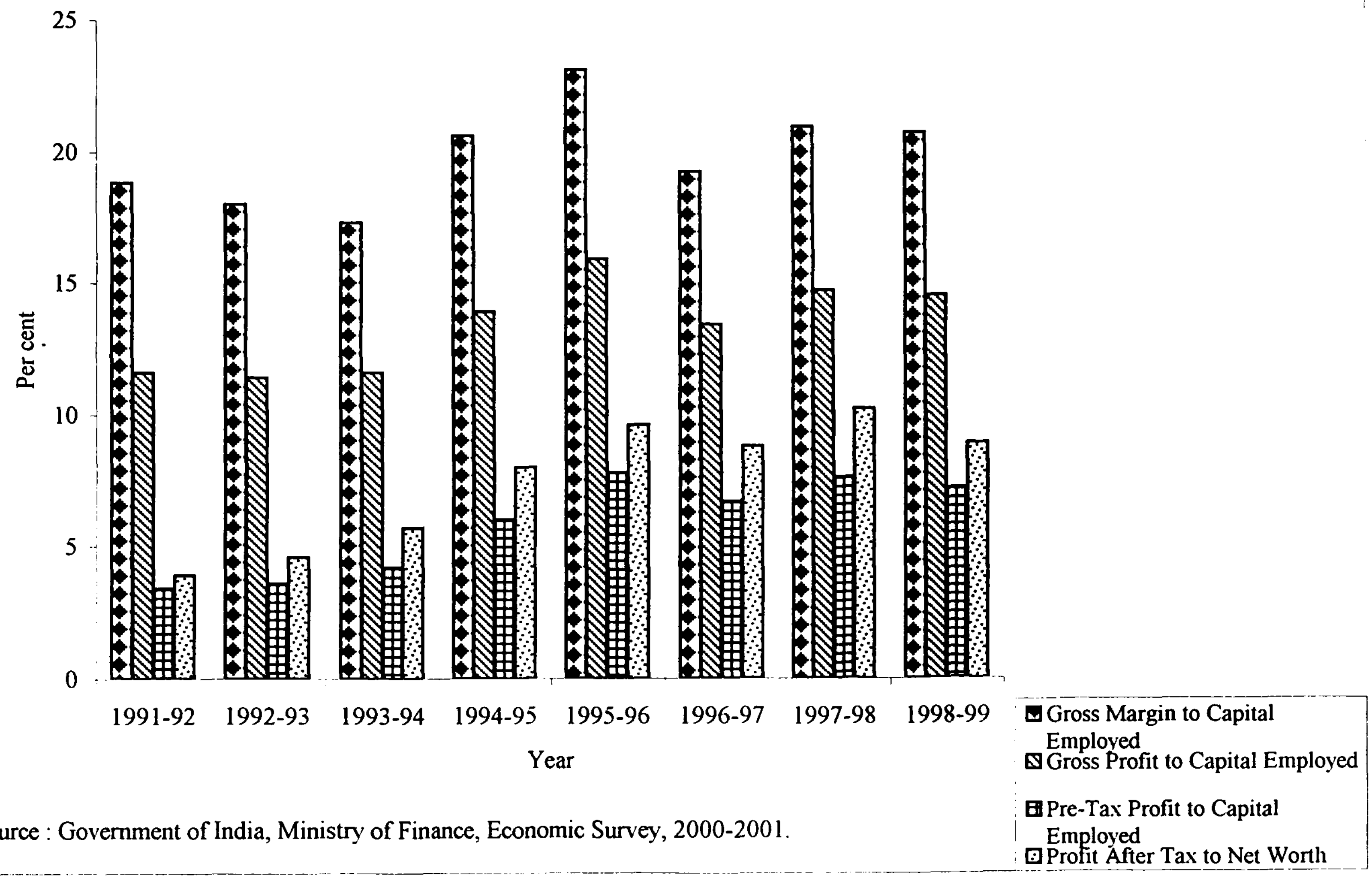
(Rs. Crore)

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99
Number of Units	237	239	240	241	239	238	236	235
Paid-up Capital	45700	51940	55970	58290	59590	62430	72120	77070
Net Worth	60330	70530	79530	89950	99180	113890	135060	148020
Capital Employed	117990	140110	159840	162450	173960	231180	253660	273700
Gross Profit	13670	15960	18560	22630	27590	30910	37210	39770
Pre-Tax Profits	4000	5080	6660	9770	13620	15380	19350	19730
Profit After Tax (PAT)	2360	3270	4550	7190	9570	10190	13720	13230
Gross Margin to Capital Employed (%)	18.8	18.0	17.3	20.6	23.1	19.2	20.9	20.7
Gross Profit to Capital Employed (%)	11.6	11.4	11.6	13.9	15.9	13.4	14.7	14.5
Pre-Tax Profit to Capital Employed (%)	3.4	3.6	4.2	6.0	7.8	6.7	7.6	7.2
PAT to Net Worth (%)	3.9	4.6	5.7	8.0	9.6	8.8	10.2	8.9

Source : Government of India, Ministry of Finance, Economic Survey, 2000-2001.

FIGURE : c-ix

PROFITABILITY OF CENTRAL PUBLIC SECTOR UNDERTAKINGS



Source : Government of India, Ministry of Finance, Economic Survey, 2000-2001.

With the adoption of the economic reforms, a second look at the public sector became inevitable. The new strategy essentially involved refocussing - not curtailing state activity and channelising resources and effort in high priority areas. This crucial shift in priority needs to be viewed in the backdrop of not merely the trends of liberalization and globalisation but the performance of the public sector itself.

Table C-11 and Figure c-ix highlights the performance of the public sector enterprises during the stabilization period. In 1991-92 pre-tax profit to capital employed was 3.4 per cent and profit after tax to net worth was 3.9 per cent which rose to 7.6 per cent and 10.2 per cent respectively in 1997-98 though this shows an improvement in rate of return on capital employed in PSUs, but the rate is still very low.

5.4.2 Disinvestment in Public Sector Undertakings

An assessment of the strategies adopted by successive governments after 1991 gto initiate and carry forward the process of reforms in the public sector indicates three critical dimensions involved in the process : a) inter-sectoral dimension, b) efficiency dimension, and c) fiscal dimension. The inter-sectoral dimension of public sector reforms implies : the wider implications of these reforms on the financial sector on the one hand and the impact of the monetary and regulatory mechanisms that have developed in the fiscal sector on disinvestment in the public sector, on the other. The multi-track impact and influence of public sector disinvestment also needs to be taken into account. The efficiency dimension implies the stress on better and more professional management of public enterprises as one of the goals of disinvestment.

The fiscal dimension involves disinvestment in order to garner resources to bridge the budget deficit. All the three dimensions have influenced the disinvestment strategy of the government, with varying degrees of assertiveness. Issues relating to disinvestment revolve around three principal questions why, how and how much. The stress on disinvestment, as against privatisation is significant. Privatisation aim at shrinking the role of the state in economic activities. Disinvestment on the other hand, has a much wider connotation as it could either involve dilution of government stake to a level that result in a transfer of management or could also be limited to such levels which would permit the government to retain control over the organisation.

Table C-12 and Figure c-x shows that during 1991-92, disinvestment yielded revenue of Rs. 3038 crore against the targetted Rs. 2500 crore. In the next year, though the budget projected Rs. 2500 crore as the estimated earnings from disinvestment, the actual figures were much lower Rs. 1913 crore. For 1993-94, the budget made a provision for Rs. 3500 crore from disinvestment but the actual earnings from disinvestment were nil. The government held unfavourable market conditions as the main reason responsible for this lacklustre trend. However, in 1994-95 Rs. 4843 crore was realised through disinvestment as against the target of Rs. 4000 crore. Perhaps, this buoyant earning from disinvestment tempted the government to set an overambitious target for the year 1995-96 of Rs. 7000 crore. But the actual earnings from disinvestment were merely Rs. 362 crore. This trend continued till 1997-98. In 1998-99, there was buoyancy in earnings through disinvestment, actual earnings were Rs. 5371 crore against Rs. 5000 crore

TABLE : C-12

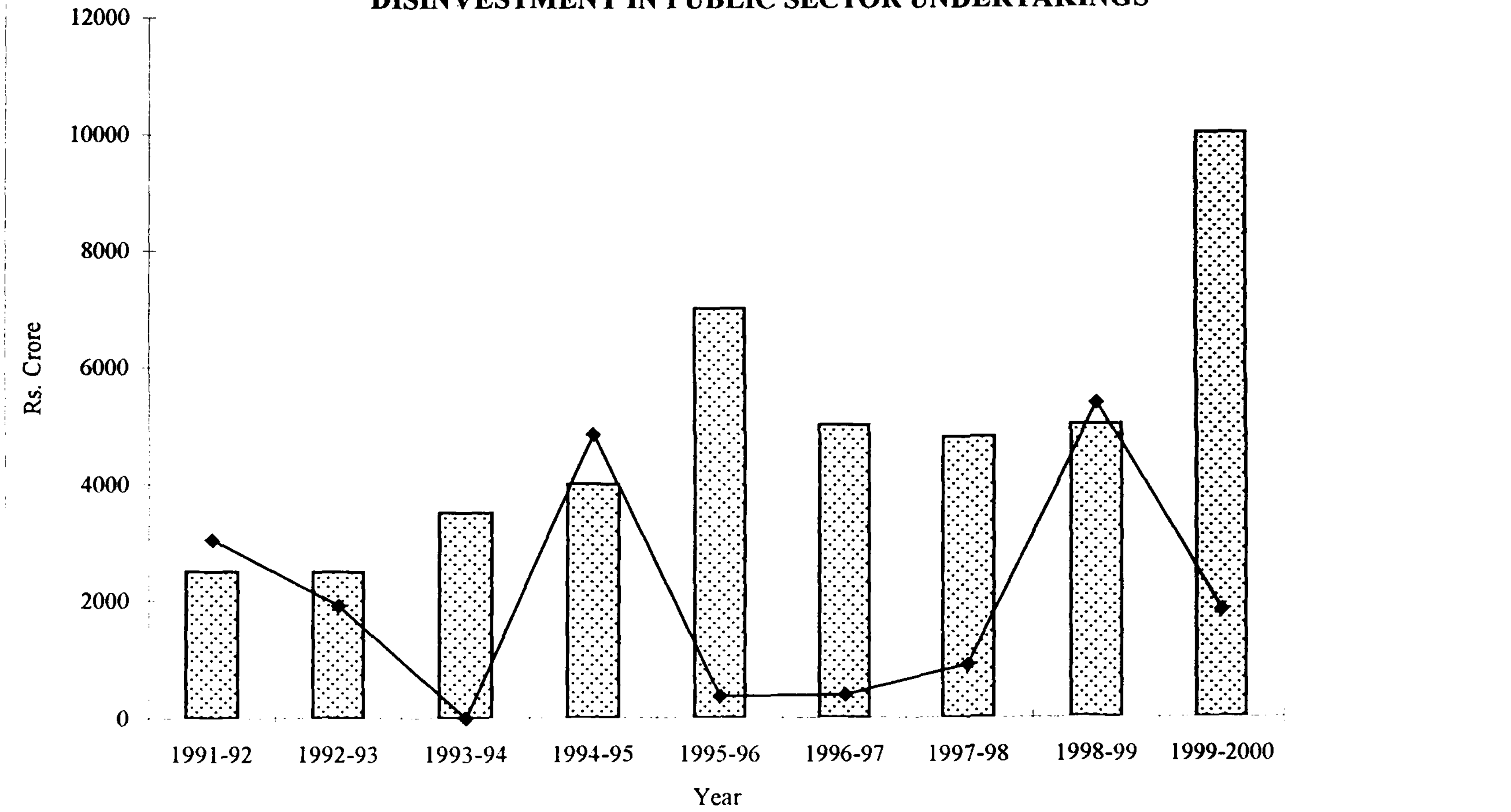
DISINVESTMENT IN PUBLIC SECTOR UNDERTAKINGS (1991-92 to 1999-2000)

Year	Target (Rs. Crore)	Achievement (Rs. Crore)
1991-92	2500	3038
1992-93	2500	1913
1993-94	3500	Nil
1994-95	4000	4843
1995-96	7000	362
1996-97	5000	380
1997-98	4800	902
1998-99	5000	5371
1999-2000	10000	1829

Source : Government of India, Ministry of Finance, Economic survey, 2000-2001.

FIGURE : c - x

DISINVESTMENT IN PUBLIC SECTOR UNDERTAKINGS



Source : Government of India. Ministry of Finance. Economic Survey. 2000-2001.

target. Again there was decline in 1999-2000 in eanrings through disinvestment.

A few distinct trends can be discerned from the above analysis of the public sector reform. The spotlight of attention was very clearly on the process of disinvestment. 'In order to give thrust to the process of disinvestment in PSUs, a new Department of Disinvestment has been set up. The department is responsible for all matters related to disinvestment of central government equity in central public sector undertakings, implementation of disinvestment decisions and recommendations of the erstwhile Disinvestment Commission'.[7]

The government had categorically stated that the funds available for disinvestment would be used for infrastructure development, upgrading technology in the public sector, investing in the social sector and for the retirement of the public debt. In reality much of the government earning through disinvestment was used to bridge the budget deficit. Many did argue that if resources raised through disinvestment were utilised for retiring past debts it would result in the reduction of the interest burden of the government, thereby strengthening the fiscal stabilization process. Whatever limited progress has been achieved in initiating public sector reforms has largely been linked to the process of disinvestment. Here too, the goal has fallen short of expectations and the disinvestment strategy has itself been bogged down by controversies. As far as long-term fiscal stabilization is concerned higher rate of return from capital employed in public sector enterprises would have been more profitable than the use of disinvestment earnings.

During 2000-2001 non-tax revenue from dividends and profits from PSUs has exceeded the budget expectations. The shortfall in disinvestment proceeds has, thus been partly offset by the increase in non-tax revenue. If the last year's pattern was any indication, attempts to mobilise revneue from disinvestment would be crucial for significant reduction in fiscal deficit so that the growth in public debt can be reduced.

5.5 FISCAL STABILIZATION AND PUBLIC DEBT

The revenue and expenditure trends as explained earlier has been to render unmanageable size of the fiscal deficit. It is notable that the beginning of the deficit issue were in the early 1980s. Till then the revenue account had been in surplus with non-plan revenue receipts exceeding non-plan revenue expenditure.[iv] This had enabled partial financing of capital expenditure from the revenue account. From early eighties, the revenue account surplus turned into deficit, but the non-plan account within the revenue account remained in surplus. This meant that the non-plan revenue surplus financed the plan revenue deficit. In the 1990s, both the plan and non-plan components of the revenue account went into deficit. Today it is not only the centre, but important states are also habitually presenting budgets with a revenue deficit. Thus both the centre and the states are running into revenue deficits. There is no indication that this policy will be corrected in the near future. Hence there is a rapid build-up of the consolidated fiscal deficit of central government. In turn, the deficit problem has resulted in a quick growth in the size of the public debt. The government debt-internal and external liabilities comprised over half of GDP. This is a high figure whose servicing has become difficult in as much as the interest burden of the central government comprises half of its total revenue. The RBI has indicated that there are likely to be steep jumps in future payments that would have to be made through increased borrowings.

5.5.1 Growth of Public Debt

Table C-13 and Figure c-xi shows values of internal debt, external debt and other liabilities of government of India at the end of each financial year from 1990-91 to 1999-2000. The table shows that the total liabilities of Government of India has increased more than three times between 1990-91 and 1999-2000, and most of the increase is on account of internal liabilities. The share of external debt in total liabilities has actually declined from 10.02 per cent in 1990-91 to 5.6 per cent in 1999-2000. The table also shows that external debt as a ratio to GDP at current market prices has also declined almost steadily from 5.5 per cent in 1990-91 to 2.9 per cent in 1999-2000. The ratio of internal liabilities to GDP has fluctuated around 48 per cent during the entire nineties and at the end of 1999-2000 it stands at 49.73 per cent. But total liabilities as a ratio to GDP has declined during this period, from 55.30 per cent in 1990-91 to 52.67 per cent in 1999-2000 (Table C-13 and Figure c-xi).

Two points are noteworthy from above discussion. First, there is a slight decline of public debt-income ratio during the period in reference, in particular during the second half of this period (i.e. 1995-96 to 1999-2000) and second and more important is that this decline in total liabilities to GDP ratio is mainly due to decline in external debt - GDP ratio. But there was not much change in the internal liabilities - GDP ratio.

TABLE : C-13

GROSS INTERNAL AND EXTERNAL LIABILITIES OF GOVERNMENT OF INDIA (1990-91 to 1999-2000)

(Rs. Crore)

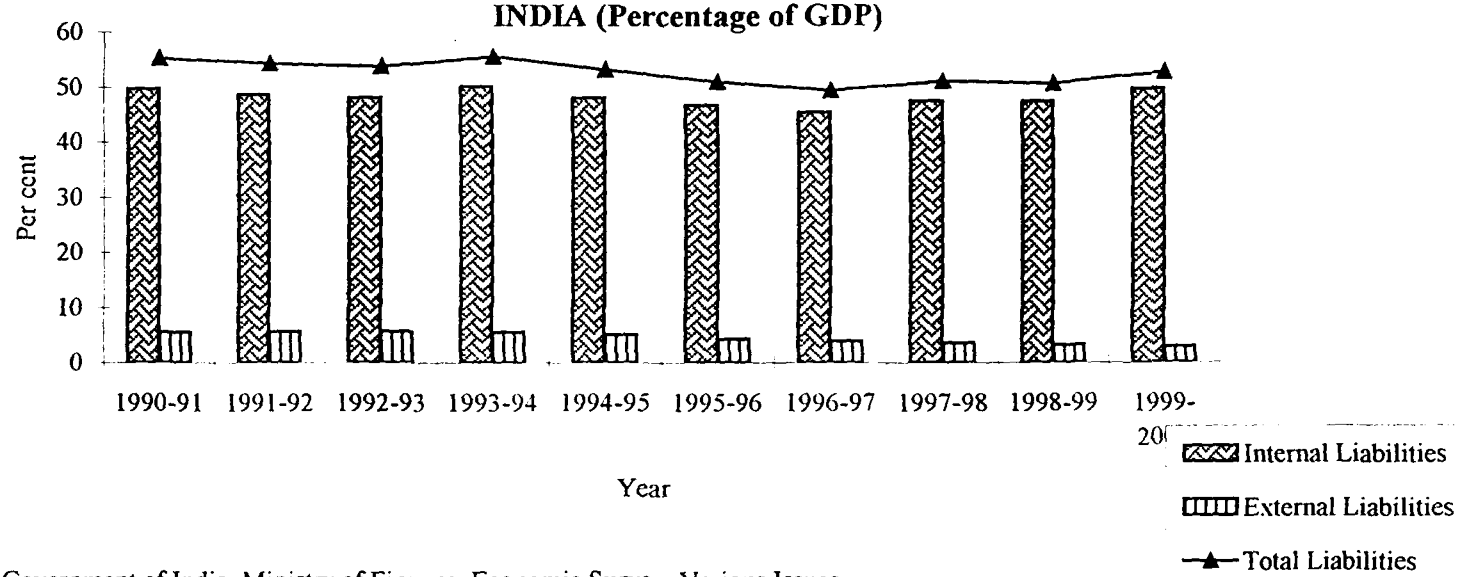
Year	Internal Liabilities	Internal Debt	Of which Market Borrowings	Other internal Liabilities	External Liabilities	Total Liabilities	As percentage of GDP		
							Internal Liabilities	External Liabilities	Total Liabilities
1990-91	283033	154004	70565	129029	31525	314558	49.76	5.54	55.30
1991-92	317714	172750	78075	144964	36948	354662	48.63	5.66	54.29
1992-93	359654	199100	81751	160554	42269	401923	48.05	5.65	53.70
1993-94	430623	245712	110680	184911	47345	477968	50.12	5.51	55.63
1994-95	487682	266467	131007	221215	50929	538611	48.15	5.03	53.18
1995-96	554984	307869	164094	247115	51249	606233	46.72	4.31	51.03
1996-97	621438	344476	184101	276962	54238	675676	45.42	3.96	49.38
1997-98	722962	388998	216598	333964	55332	778294	47.49	3.63	51.12
1998-99	834551	459696	285584	374855	57255	891806	47.46	3.26	50.72
1999-2000 (R.E.)	973141	728627	362650	244514	57603	1030744	49.73	2.94	52.67
1990-91 to 1994-95 Avg.	-	-	-	-	-	-	48.94	5.48	54.42
1995-96 to 1999-2000 Avg.	-	-	-	-	-	-	47.36	3.62	50.98

Note : R.E. (Revised Estimate), Avg. (Average).

Source : Government of India, Ministry of Finance, Economic Survey, Various Issues.

FIGURE : c - xi

GROSS INTERNAL AND EXTERNAL LIABILITIES OF THE GOVERNMENT OF INDIA (Percentage of GDP)



Source : Government of India, Ministry of Finance, Economic Survey, Various Issues

It appears that the high internal liabilities - income ratio is less on account of government of India's lendings to state governments and public enterprises[v] and more on account of Government of India's own account fiscal requirements.

5.5.2 Debt Servicing and Other Implications

Debt servicing is viable so long as debt servicing - repayment of debt and interest does not distort fiscal balance and the debt. The burden of debt servicing depends not only on the amount of debt and interest but also on maturity and mode of interest payments. B.B. Bhattacharya and S. Guha points out in this regard,

'The burden is relatively higher on shorter maturity of debt. The actual debt burden is however not always reflected properly in the budget. If there is no amortisation and debt has to be paid in lump sum at the end of maturity period then the budget for the intermediate period will not reflect the true burden of debt servicing. Similarly if there is no annual payment of interest rate and entire interest due is paid at lump sum at the end of the maturity period then the budget for the intermediate period will not reflect true burden of debt servicing. In practice debts are of various types with different maturity, interest rates and mode of repayment, and so the relative burden of debt servicing would depend on relative weights of alternative types of debt'.[8]

Table C-14 and Figure c-xii shows that the interest cost of internal pbulic debt of Government of India has risen over the years. Debt service payments of the central government have risen inexorably from about 40 per cent of tax revenues in 1985-90 to about 66 per cent in

TABLE : C-14

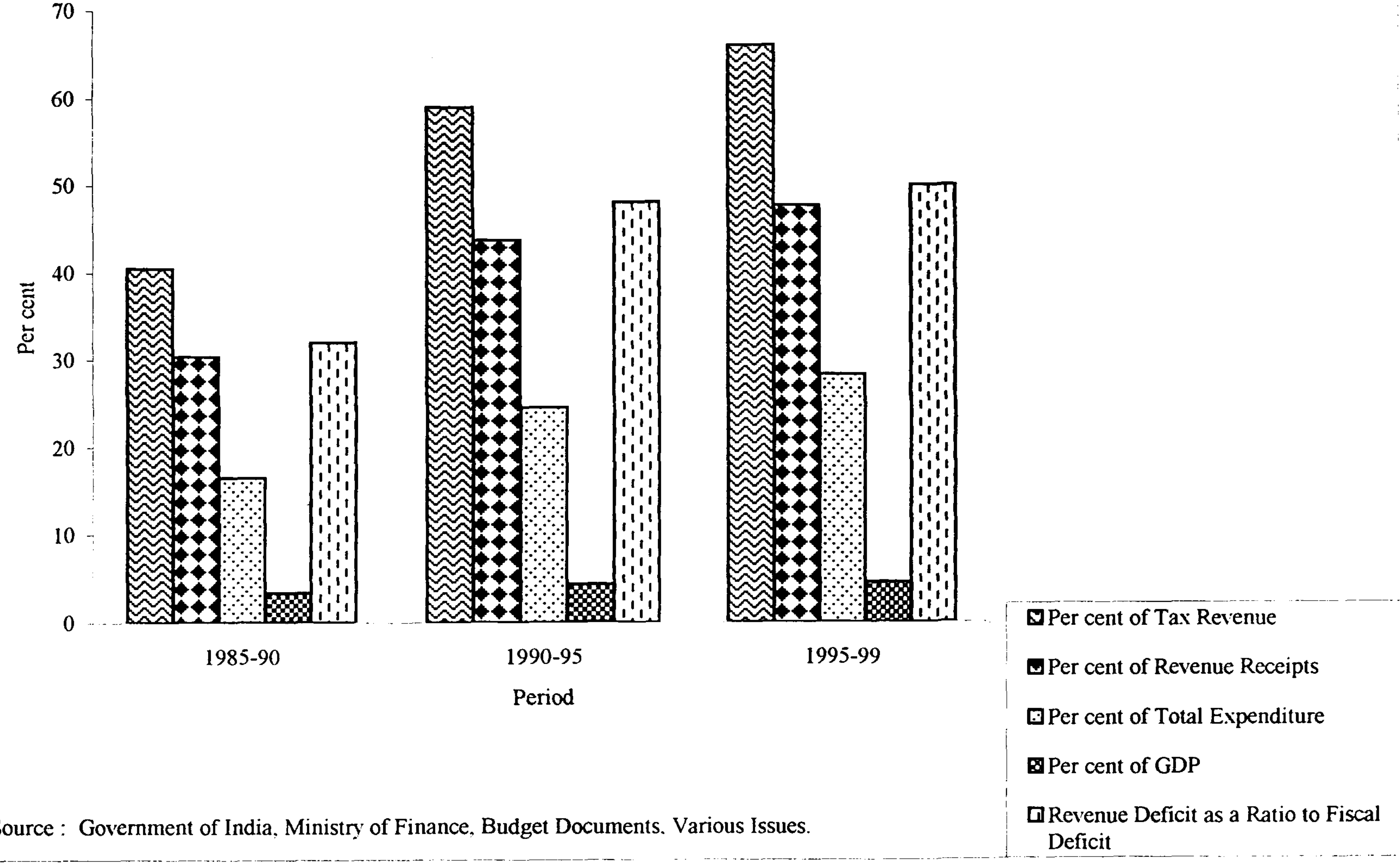
BURDEN OF RISING DEBT SERVICE OF THE CENTRAL GOVERNMENT (As per cent of :)

Period	Tax Revenue	Revenue Receipts	Total Expenditure	GDP	Revenue Deficit as a ratio to Fiscal Deficit.
1985-90 (Avg.)	40.5	30.4	16.5	3.4	32.00
1990-95 (Avg.)	58.9	43.7	24.6	4.4	48.00
1995-99 (Avg.)	65.9	47.6	28.3	4.6	50.00
1997-98	68.6	49.0	28.3	4.6	-
1998-99 (R.E.)	70.5	49.0	27.4	4.8	-
1999-2000 (B.E.)	71.7	50.8	31.0	4.9	-

Note : R.E. (Revised Estimate), B.E. (Budget Estimate), Avg. (Average).

Source : Government of India, Ministry of Finance,Budget Documents, Various Issue.

FIGURE : c - xii
BURDEN OF RISING DEBT SERVICE OF CENTRAL GOVERNMENT



Source : Government of India, Ministry of Finance, Budget Documents, Various Issues.

1995-99 and around 72 per cent in 1999-2000. The day is not far off when the tax revenues will equal debt service payments. As a proportion of total revenue receipts debt service has increased from about 30 per cent in 1985-90 to about 51 per cent in 1999-2000. As a proportion of total expenditure, debt service payments have increased from about 16.5 per cent in 1985-90 to about 31 per cent in 1999-2000. As a ratio to GDP, debt service payments have increased from 3.4 per cent in 1985-90 to about 4.6 per cent in 1995-99 and around 5 per cent in 1999-2000. Another consequence of rising debt srevice is that the revenue deficit has increased form about 32 per cent as a proportion of fiscal deficit in 1985-90 to about 50 per cent in 1995-99. In other words, half of current borrowing goes to finance curent expediture. By definition curent expenditure yields on economic returns in the future and hence debt service payments will contiuue to rise in the forseable future unless a significant connection is made in this situation.

With increasing levels of borrowing to finance activities which have zero or low yields, interest payments increase inexorably. Thus non-productive committed current expenditures rise giving rise to higher and higher revenue deficits. This leads to yet higher and higher borrowing levels. Because of debt service payments forming a higher proportion of both revenues and expenditures on all other activities of the government suffer, since wages and salaries, interest payments, defence expenditures, pensions, food subsidies are all committed expenditures with little or no flexibility. The main sufferer in this process is government capital expenditure in both social and infrastructure facilities. High debt service payments also preclude increase in or even maintenance of current real levels of expenditures in social services.

The continued high levels of public borrowings also have an effect on the rest of the economy through prevalence of high interest rates. Because of the necessity to finance government deficits the Reserve Bank of India has to keep the level of both CRR and SLR high on deposits in commercial banks. This leads to the necessity for banks to have higher margins on their commercial activities thereby subjecting the rest of the economy to high interest rates. Moreover, because of the voracious appetite of the government for garnering resources from the whole financial sector, including small savings, insurance and the like, the continued high fiscal deficit levels also impede financial sector reforms which are necessary for the economy to achieve higher efficiency levels. With this scenario the possibility of achieving fiscal stabilization would seem rather difficult.

Finally, there is indeed a ray of hope for the taming of the deficit problem. The recent turnout of the central government's fiscal accounts demonstrates that the budget objectives of around 5 per cent fiscal deficit as a ratio to GDP has been met. It seems that the deficit problem is being squarely addressed as the primary economic issue to be tackled and the numbers seem to indicate so. However, when the consolidated public sector including state governments, public enterprises and the oil pool account are considered, a staggering deficit figure of over 10 per cent of GDP is arrived at. Clearly, the deficit problem remains well ensconced on the economic horizon, and the likelihood of a bequest of a phenomenal public debt to posterity remains quite real.

5.6 TRENDS IN DEFICIT OF THE CENTRAL GOVERNMENT DURING STABILIZATION PERIOD (1991 ONWARDS)

There are various measures of fiscal imbalance which we have already discussed. Here we would like to highlight only three measures i.e. revenue deficit, primary deficit and fiscal deficit. The revenue deficit is a measure which shows the excess of current expenditure over the current receipts. The primary deficit is the fiscal deficit net of interest payments which reflects the current fiscal stance of the government. And finally, there is the fiscal deficit which measures the total borrowing requirements of the government. Table C-15 and Figure c-xiii shows that revenue deficit during the first five years of stabilization period was 3.04 per cent as a ratio to GDP which rose to 3.08 per cent in the second period. This higher revenue deficit reflects the growing mismatch between revenue receipts and revenue expenditure. Main factor responsible for the mismatch is interest payments. Due to higher interest payments during the period in reference growth of revenue expenditure is also higher as compared to revenue receipts, which creates a huge revenue deficit. Even after ten years of fiscal stabilization process persistent high revenue deficit proves to be a serious threat to the fiscal health of the economy. Primary deficit, which measures fiscal deficit net of interest payments shows the seriousness of the fiscal problem created by interest payments. Primary deficit declined from 1.34 per cent during 1990-91 to 1994-95 to 0.36 per cent during 1995-96 to 1999-2000. The sharp decline in the primary deficit clearly indicates that government has been successful to some extent in tackling the problem of fiscal instability. Though, revenue deficit has been increased during the stabilization period on the one hand,

TABLE : C-15

TRENDS IN PARAMETERS OF DEFICIT OF THE CENTRAL GOVERNMENT (1990-91 to 2000-2001) (As Per cent of GDP)

Year	Revenue Deficit	Primary Deficit	Fiscal Deficit
1990-91	3.3	2.8	6.6
1991-92	2.5	0.7	4.7
1992-93	2.5	0.6	4.8
1993-94	3.8	2.2	6.4
1994-95	3.1	0.4	4.7
1995-96	2.5	0.0	4.2
1996-97	2.4	-0.2	4.1
1997-98	3.1	0.5	4.8
1998-99	3.9	0.7	5.1
1999-2000 (Provisional)	3.5	0.8	5.5
2000-2001 (B.E.)	3.6	0.5	5.1
1990-91 to 1994-95 (Avg.)	3.04	1.34	5.44
1995-96 to 1999-2000 (Avg.)	3.08	0.36	4.74

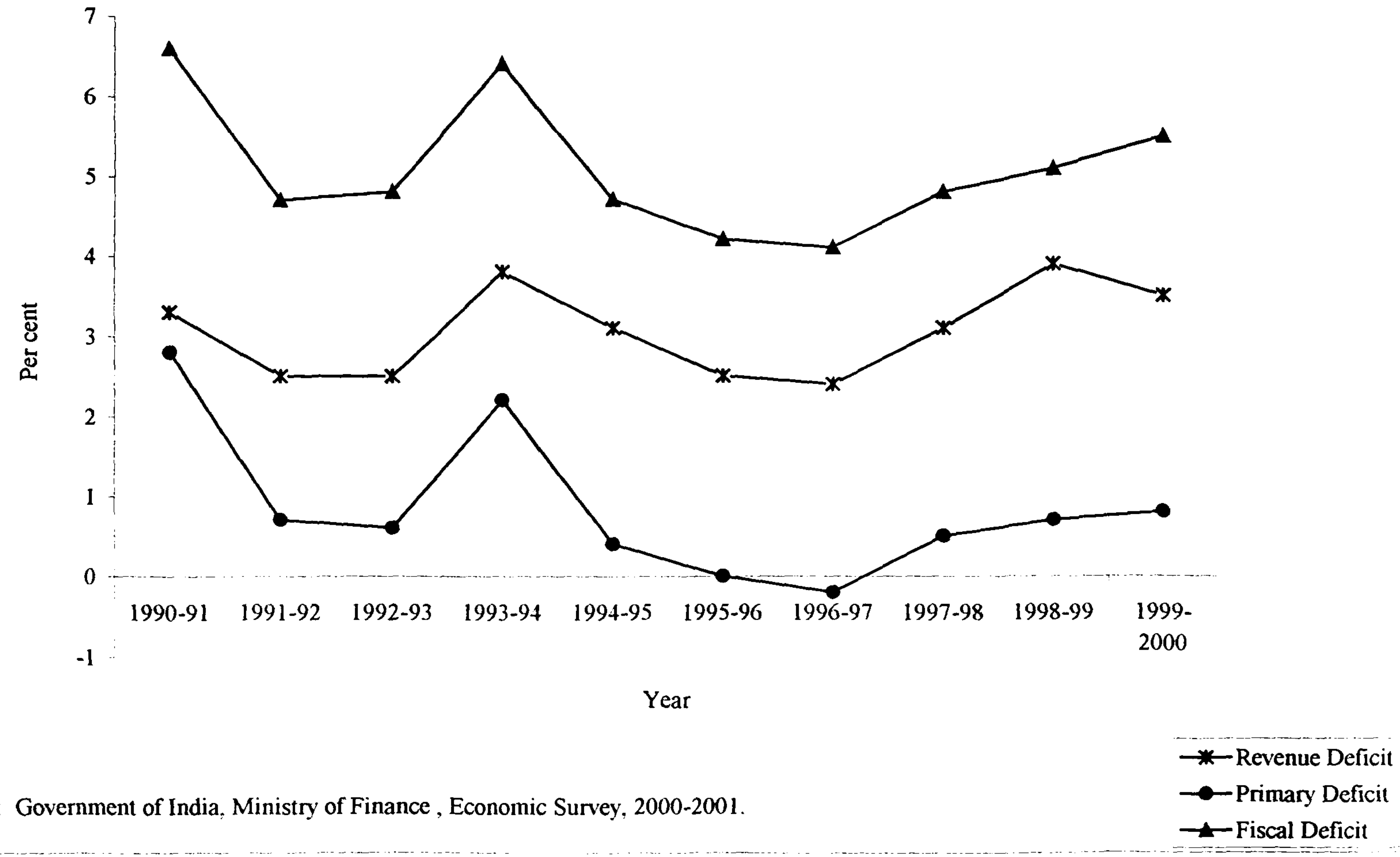
Note : **1.** Ratios to GDP at current market prices (Base : 1993-94)
2. The Fiscal Deficit excludes the transfer of states' share in the small savings collections

Source : **1.** Government of India, Ministry of Finance, Economic survey, 2000-2001.

FIGURE : c - xiii

TRENDS IN PARAMETERS OF DEFICIT OF THE CENTRAL GOVERNMENT

(As Percentage of GDP)



Source : Government of India, Ministry of Finance , Economic Survey, 2000-2001.

fiscal deficit has been declined on the other during the same period. Fiscal deficit has declined from 5.44 per cent of GDP in 1990-91 to 1994-95 to 4.74 per cent in 1999-2000. Decline in fiscal deficit was not as much as expected due to higher interest payments.

Thus, we can say that for the long term fiscal stability government must retire it's debt, which will reduce the level of interest payments. This is possible by the way of using a part of disinvestment proceeds for this purpose.

5.6.1 Financing of the Fiscal Deficit

Government debt rises when government expenditure-current and capital exceeds its income i.e. tax and non tax current revenue, interest receipts and profits from public seetor undertakings. Normally the government makes a saving in current account and utilises it for financing a part of its capital expenditure. The deficit in capital account raises public debt Table C-16 shows that in the period-I revenue expenditure exceeds revenue receipts of the government. The gap between the two increased in the period-II which it is more than 3 per cent of GDP and still rising. The basic reason for this appears to be almost stagnant tax-GDP and revenue -GDP ratio in the last period. It is evident from table C-16 that total government expenditure as a proportion of GDP declined from an average of 17.6 per cent in period-I to 14.9 per cent in period-II. However, the ratio of capital expenditure and revenue expenditure as per cent of GDP over the same period shows different trends. The fall in the share of capital expenditure as per cent of GDP in period-II reflects deceleration in the growth of capital expenditure. It also shows that the

TABLE : C-16

TRENDS IN SELECT FISCAL PARAMETERS OF THE CENTRAL GOVERNMENT

(1980-81 to 1991-92 and 1992-93 to 1999-2000) **(Average Annual Pre cent)**

	1980-81 to 1991-92 As per cent of GDP (Period-I)	1992-93 to 1999-2000 As per cent of GDP (Period-II)	1980-81 to 1991-92 Growth rate (Period-I)	1992-93 to 1999-2000 Growth rate (Period-II)
Total Expenditure	17.6	14.9	15.5	13.9
(a) Revenue Expenditure	11.7	12.2	17.7	15.0
(b) Capital Expenditure	5.9	2.7	11.1	9.9
Gross Tax Revenue	10.0	9.1	15.5	12.7
Direct Taxes	2.0	2.7	15.5	18.6
(a) Corporation Tax	1.1	1.3	16.4	18.9
(b) Income Tax	0.9	1.2	14.8	18.6
Indirect Taxes	7.9	6.3	15.4	10.9
(a) Custom Duties	3.2	2.7	18.7	11.1
(b) Excise Duties	4.5	3.4	13.8	10.6
Revenue Receipts [a]	9.8	9.1	16.1	13.7
Tax Revenue [a]	7.4	6.6	15.9	12.9
Revenue Deficit	1.9	3.1	-	-
Gross Fiscal Deficit	6.6	5.0	-	-

Note : 1. (a) Net to centre.
2. Ratios to GDP at Current Market Prices (Base : 1993-94)
3. Figures for 1990-91 onwards are exclusive of the transfer to state' share of small savings collections.

Source : Government of India, Ministry of Finance, Economic Survey, 2000-2001.

share of gross tax revenue (net tax revenue) as a proportion of GDP has fallen from 10.0 per cent (7.4 per cent) on an average in period-I to 9.1 per cent (6.6 per cent) in period-II. This has been accompanied by some significant structural changes in the composition of tax revenue. Over the same period, the share of direct taxes GDP has incereased and that of indirect taxes fallen. Direct taxes are less distortionary and more inequitable in impact vis-a-vis indirect taxes. Revenue deficit as a proportion of GDP on an average basis swelled from 1.9 per cent in period-I to 3.1 per cent in period-II while similar ratio for gross fiscal deficit shows a decline. This reflects that borrowings during period-II were mainly used for current consumption rather than investment.

The difference between government total expenditure (current plus capital) and income is government deficit, which has to be financed through borrowing from various sources : external, internal banking and non-banking private sector. Table C-17 & Figure c-xiv shows that there is a perceptible shift towards market related borrowings in the financing of gross fiscal deficit in period-II. The share of market barrowings in the financing of fiscal deficit increased form an average of about 26 per cent in period-I to about 50 per cent in period-II. External assistance is no longer an important source of financing the fiscal deficit of the government. As it is shown in table C-17 and Figure c-xiv that the share of external financing has been declined to 5.2 per cent of the total financig in the period-II from 10.3 per cent in period-I. Earlier, a substantial portion of the fiscal deficits was financed by monetisation. This is no longer resorted to and hence the explicit interest cost of the fiscal deficit

TABLE : C-17

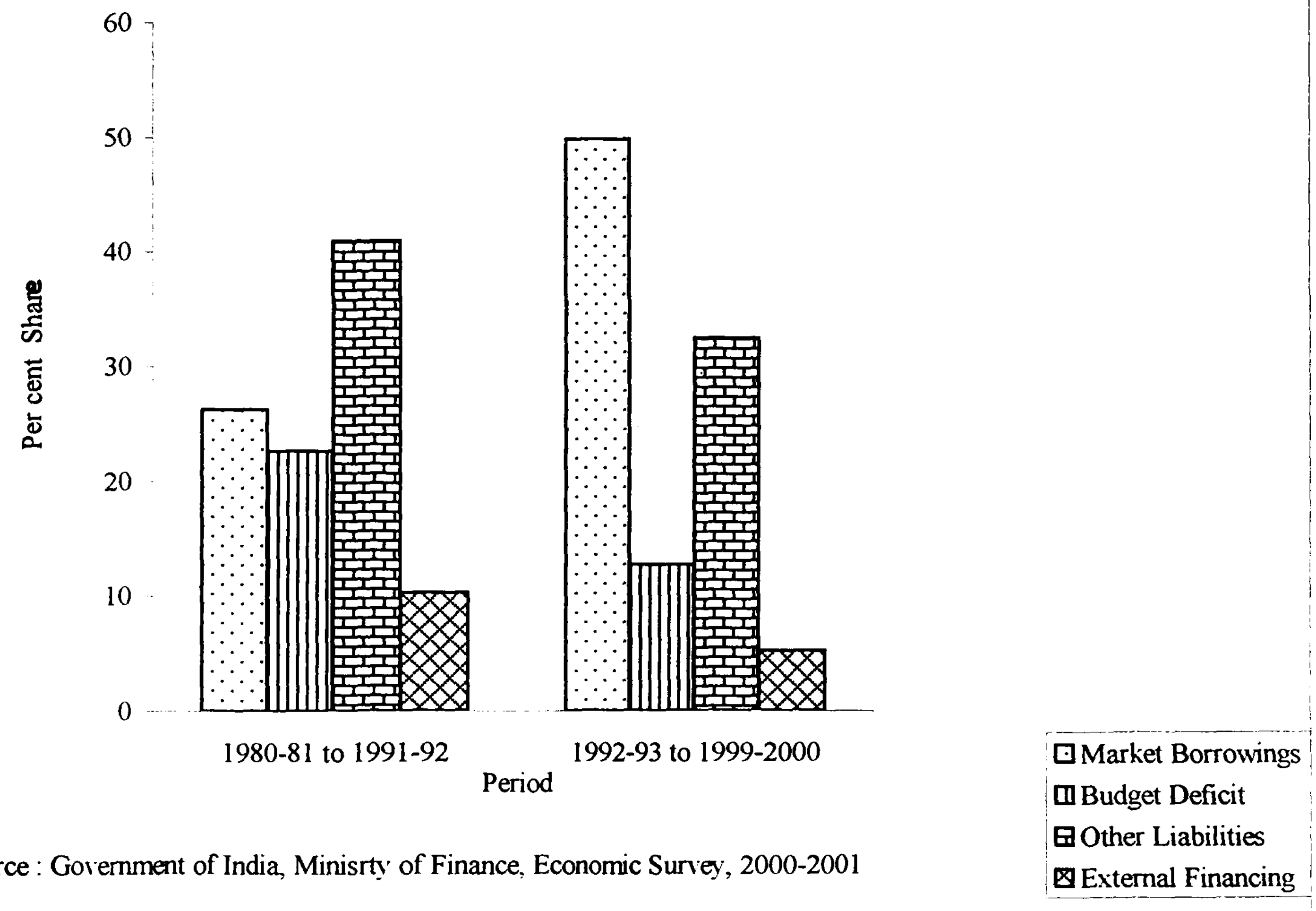
FINANCING OF THE GROSS FISCAL DEFICIT (Per cent share)

	1980-81 to 1991-92	1992-93 to 1999-2000
Market Borrowings	26.2	49.7
Budget Deficit	22.6	12.7
Other Liabilities	40.9	32.4
External Financing	10.3	5.2

Source : Government of India, Ministry of Finance, Economic survey 2000-2001.

FIGURE : c - xiv

FINANCING OF THE GROSS FISCAL DEFICIT (Per cent Share)



Source : Government of India, Minisrty of Finance, Economic Survey, 2000-2001 has consequently increased, which in turn induces more revenue deficit and eventually total deficit. 'One way to break this dynamic growth of public borrowing would be to reduce the primary deficit, that is budget deficit minus interest payment'.[9]

As of now there is evidence of decline in the fiscal deficit in the recent years. Thus, in the immediate future there is possibility of a decline in internal debt-GDP ratio of the central government. As a result the problem of fiscal instability might be solved to some extent.

Thus it is clear from above discussion, that the 1990s have witnessed a fall in the collection of tax revenue as a proportion of GDP in general and a fall in the collection of indirect taxes as a proportion of GDP in particular. However during the same period revenue expenditure as a ratio to GDP shown a rising trend. This mismatch between revenue and expenditure resulted in sizeable revenue and fiscal deficits which was financed by borrowing. As a result of excessive borrowings interest burden further increased which inturn increased the revenue expenditure.

There is wide agreement that the budgets of the government were out of balance in the recent past and now the restoration of fiscal balance is one of the most urgent tasks in the agenda of further economic reform. There is not only a wide gap between revenue and expenditure resulting in deficits; the composition of the government expenditure is also quite out of line with the proper role that the government should be playing and the functions they should be performing at the present stage of development. It could also be argued that the revenue structure needs to be altered to make it more broad-based and equitable. Thus, a significant structural reform of the budget is needed as much as the reduction of the fiscal deficit. In this regard Chelliah, R.J. et al. (1996) suggested that :

'Reduction in revenue and fiscal deficits requires faster growth in revenues and slower growth in public expenditure. The process of fiscal adjustment to reduce deficits must incorporate the needed structural changes. In other words, the rate of growth of revenues must be raised and the growth of expenditures slowed down in such a manner that structure of public finances will be simultaneously changed in the desired direction'.[10]

NOTES

i) Eminent economist, Arthur Laffer has argued that lower tax rates are quite consistent with the increase in tax revenue. He has shown the relationship between tax rates and the total tax revenue collected with the help of a curve named after him as Laffer curve.

ii) It is more transparent to fulfil the government's redistribution objective through the expenditure system by directly targeting the weak and vulnerable. This is not, however, a full solution since it is typically difficult to set up appropriate and adequate delivery mechanisms. Nevertheless, expenditure seems to be better suited to the objective than is the tax structure which tends to become distorted as multiple objectives creep into it.

iii) Though there is a complementarity between primary health care and population control. But other significant determinants of the latter are female education, child nutrition, safe water supply and sanitation. A cogent population policy should need to incorporate all these elements.

iv) The revenue account includes tax revenue, interest receipts and dividends on the receipts side. On the expenditure side are included interest payments, wages and salaries and subsidies. These relate to general, economic and social services (including defence). Capital accounts receipts include recovery of loans, disinvestment and borrowings while expenditures relate to capital formation (plan or non-plan). Plan expenditure relates to capital expenditure on programmes as well as plan driven revenue expenditure on operations and maintenance in a current plan. Non-plan expenditure includes operations and maintenance on assets created in previous plans apart from interest payments, subsidies, defence, and wages and salaries on other non-plan expenditure.

v) State governments and public enterprises often failed to honour their debts to government of India, resulting in either government of India absorbing a part or whole of the debt as its own debt or rescheduling the payment.

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Chapter - 6

CONCLUSIONS AND SUGGESTIONS

6.1 CONCLUSIONS

We have made an attempt in the foregoing chapters to examine the problem of fiscal stabilization in Indian economy since seventh plan (i.e. since 1985). The analysis of the foregoing pages shows that the origins of the fiscal crisis in the developing countries was in stagnant revenues coupled with uncontrolled expenditures, alongwith foreclosed foreign borrowings. As a result governments had to rely on domestic sources of financing, which could result either in runaway inflation or pushed the economy into debt-trap or in a combination of both.

Chapter II tries to explain that most of the developing countries where there was a fiscal crisis, have registered a decline in the share of the direct taxes in general and that of income taxe in particular in total revenues. Simultaneously, higher rates of custom duties further reduced the buoyancy of the tax system in such countries. Thus, chapter-II concludes that experience of developing countries reveals that the emergence of the fiscal crisis was result of stagnant revenues alongwith rapid growing public expenditures and public debt. The fiscal crisis forced many countries to undertake fiscal stabilization programmes. Chapter II has surveyed some major issues that arise in the process to overcome the problem of fiscal stabilization. It also analysed possible effects of the fiscal stabilization measures, its quality and its sequencing. Finally, we can say, that the objective of fiscal stabilization cannot be achieved through shock therapy. However, good fiscal measures always took time in the restoration of fiscal stabilization.

During the seventh plan period (1985-90) the fiscal sector of the economy was possibly in the severest crisis in the post-independence era. All symptoms were almost similar as experienced by the developing countries, discussed in chapter-II. An analysis of chapter-III reveals that the government expenditure had been outpacing revenues since late seventies, leading the government to resort to substantial borrowings. The public debt reached to such a level that interest payments turned out to be the largest component of public expenditure. From 11.6 per cent in 1980-81 interest payments as a share of total expenditure increased to 21.4 per cent in 1990-91. Non-plan expenditure increased uncontrolled during the period in reference. In the realm of tax revenue, during the 1980s the ratio of total tax revenue to GDP had moved up from 9.93 per cent in 1980-85 to 11.20 per cent in 1985-90. A major problem with the tax system was that the share of direct taxes had virtually stagnated during the seventh plan period, it was 2.41 per cent in 1980-81 and averaged around 2.49 per cent of GDP in 1988-89. Thus the entire increase in the tax to GDP ratio has been brought about by exploiting indirect taxes. As it has been discussed in chapter-II in most of the economies where fiscal crisis incepted, direct taxes (which is considered most buoyant) as a ratio to GDP were either stagnant or on decline. India, also experienced the same trend along with high import duty.

It has also been recognized in the foregoing analysis that it is the progressive acceleration of government expenditure growth which has led to the emergence of a fiscal crisis despite a steady increase in the tax-GDP ratio during 1980s, which exceeded the long-term fiscal policy targets in every year of the seventh plan period. The largest increase in the share of revenue expenditures over the period came about on account of increase in interest payments. Government expenditure in India during the seventh plan period grew at a rapid rate, faster than both GDP and government revenues, with low and declining level of cost recoveries. The analysis of the trends in public expenditure during the second part of the eighties have shown sharp increase in expenditures on quasi-public goods, subsidies and transfer payments. The increasing share of current expenditures and, particularly, those on wages and salaries, food and fertilizer subsidies and sharp reduction in the share of capital expenditures have also been evidenced. The foregoing analysis have shown that the public debt to GDP ratio increased throughout the eighties, going upto almost 59 per cent at the end of the decade. As is now well known, the proximate reasons for this situation were the failure of the public sector enterprises to generate investible resources and the explosive growth of current expenditure of the government. In such a situation falling of the government into debt-trap was real. The failure of the public sector enterprises to generate profits have also contributed to the fiscal crisis, because these enterprises have dominated the provision of infrastructure and critical intermediates. Their inefficiency has led to downstream inefficiencies in a multiplier fashion. Then again, the restrictive trade and industrial licensing framework, for instance, led to serious loss of efficiency by reducing the scale of output, eliminating effective competition, creating bottlenecks, etc. which resulted in the reduction of returns, thereby affecting the GDP growth. In turn, the revenues raised from the economy, for any given tax rates were adversely affected, and the necessity to undertake budgetary expenditures to support the creation of public sector jobs and for consumption, contributed to the fiscal deficit.

Gross capital formation out of budgetary resources, which comprised 40.1 per cent of total expenditure in 1980-81, had steadily gone down to 32.7 per cent by 1990-91. Two other features need to be mentioned in this context. First, gross capital formation out of budgetary resources, which grew at an average rate of 18.8 per cent in the early eighties, appears to have started to decline from 1986-87. Secondly, the rate of increase in gross capital formation turned negative in 1990-91. In the meantime the gross savings of the government had turned negative for the first time in 1984-85, and dissaving has been growing over the years.

The impact of the above trends resulted in the expansion of money supply. Alongwith the large revenue deficits there was large budget deficits during the seventh plan period. This in turn had contributed to a large monetised deficit. Money supply grew at an average annual rate of about 17.5 per cent during the seventh plan period. This contributed to the double digit increase in CPI inflation during 1990-91. Thus, foregoing analysis reveals that by the end of eighties, a severe problem of fiscal stabilizaiton emerged. All the indicators of fiscal imbalance were on rise throughout the eighties. During this period the gross fiscal deficit rose from 6.2 per cent of GDP in 1980-81 to 8.3 per cent in 1990-91, the revenue deficit registered similar trend and rose to 3.5 per cent of GDP in 1990-91 from 1.5 per cent in 1980-81. The fiscal imbalance, fuelled by the revenue and budget deficit and financed by the borrowings and the decumulation of reserves, was accompanied by accelerated inflation to double-digit levels. Such a fiscal situation had become unsustainable.

To remove the deficit and bring fiscal stability, fiscal stabilization measures were introduced in 1991. The essential features of the central government's overall fiscal strategy for controlling the budgetary deficit comprises : expenditure compression, reduction in subsidies, reduced budgetary allocations to public enterprises, rationalised adminsitered prices, and completion of tax reforms. An analysis of chapter-IV reveals that the government had reduced provision for subsidies in respect of fertilizers, food and export promotion. The provision of subsidy in respect of Public Distribution System (PDS) was difficult to eliminate, but could be restricted to the non-affluent. This however was more easily said than done; government in a democratic setup functioned under several compulsions and constraints. Even then government was making efforts to reduce subsidies through increases in prices of commodities supplied under the PDS. Reduction in interest burden postulated sizeable reduction in borrowings, and in order to tackle the problem at its roots, the budgetary strategy had to be revised : it was necessary to revert to the formulation of a surplus budget on revenue account. Another area of expenditure, in which effective cuts were proposed, was administration and grants. Thus, government in its fiscal stabilization measures had proposed to reduce expenditure both plan as well as non-plan.

With double digit inflation, and high budget and fiscal deficit and the precarious foreign exchange and current account position in 1990-91, the fiscal stabilization programme was directed inter alia at drastically cutting the budget deficit and tightening monetary policy with the objective of reducing inflation and achieving external sector viability. Reforms in the public sector enterprises have also been introduced in the form of disinvestment and autonomy etc. The government needed to increase revenues in order to contain the fiscal deficit, as also to improve the ratio of taxes to GDP. Government proposed to implement various suggestions made by the Chelliah committee on tax reforms. In the field of direct taxes, the TRC recommended moderate direct tax rates with reduced tax deductions and exemptions, coupled with effective enforcement. Gradual reduction in both personal and corporate taxation was envisaged for the future. Customs tariff reform includes : gradual reduction in average tariff level, rationalisation of customs duties and import policies for consumer goods in a phased manner, and exemptions from countervailing duty eliminated. These measures were designed to ensure that the Indian economy becomes competitive and integrates with the global economy through freer trade. While MODVAT would be extended to all sectors, the ultimate objective was to move to a full fledged value added tax (VAT). Tax base should be widened to include exempt commodities and some services. A significant feature of tax reforms would be to move towards only one or two rates for raw materials and intermediate goods.

India's experience regarding impact of fiscal stabilization measures shows that efforts at restoration of fiscal stability proved difficult on account of certain factors as it has been experienced by various countries where IMF assisted fiscal stabilization programmes are in operation.

excise duties and raising that of direct taxes. The shift away from foreign trade taxes and excise duties appears to have taken place at the cost of overall revenue growth. The rise in the relative share of direct taxes has resulted partly from the decline in the revenue from customs and excise.

The foregoing analysis indicates towards the lack of success with expenditure reduction. There has been a sharp rise in interest payments. It is clear that the compensation has come not only from decreases in other items of current expenditure such as subsidies, defence and general administration, but also capital and plan expenditures. Throughout the 1990s, while capital expenditures as a proportion of GDP have fallen sharply, the revenue expenditures net of interest payments have stagnated. It is evident in the foregoing analysis that the ratio of capital expenditures to GDP has fallen from about 6 per cent in 1990-91 to 2.6 per cent in 1999-2000. Though, the ratio of net revenue expenditures which fell sharply between 1990-91 and 1996-97, has risen in recent times, but well below to its 1989-90 figure. Despite this the fiscal deficit is proving uncontrollable. If we use the older definition of the fiscal deficit, which included small savings transferred to the states, the fiscal deficit to GDP ratio which fell from 7.9 per cent in 1990-91 to 4.9 per cent in 1996-97, has since risen to 7 per cent in 1999-2000 and was expected to remain at around 6.8 per cent in 2000-2001.

Economic reforms have also meant a change in the way the government's deficit is financed. Till the early 1990s, a considerable part of the deficit on the government's budget was financed with borrowing

It is clear from the foregoing analysis of chapter-V, that the 1990s have witnessed a fall in the collection of tax revenue as a proportion of GDP. Between 1990-91 and 1999-2000, when there were substantial tax rates reductions the ratio of gross tax revenue to GDP declined from 10.8 per cent to 9.2 per cent. (155 A remarkable feature of the centre's revenue trends in the reform years brought out by the foregoing analysis is the jump in the share of direct taxes of the total tax revenue from around 19 per cent in 1985-90 to 29 per cent in 1995-99, and was expected to reach at around 32 per cent level in 1999-2000. Acceleration of collections from corporation tax is particularly striking, from 9.6 per cent of the total revenue in 1985-90 to around 15.4 per cent in 1995-99, and stood at around 17.2 per cent in 1999-2000. Personal income tax has also shown greater buoyancy in the reform period, from 9.12 per cent of the total revenue during 1985-90 rose to around 14 per cent during 1995-99. The leap in revenue from direct taxes, however, has not been able to neutralise the decline that has taken place in the indirect taxes. Revenue from customs and excise, which together accounted for over 79 per cent during 1985-90 has declined to 66 per cent during 1995-99. Revenue from indirect taxes had started decelerating even before the reforms but the decline has been sharper in the reform period. There has been a noticeable shift in the tax structure at the centre. The two key aims of the reforms, viz., lessening the weight of foreign trade taxes and increasing that of direct taxes, are evidently materialising. The rise in the share of income tax has, however, not sufficed to make-up fully for the loss from the tariff reforms. In sum, reforms so far have succeeded in making a small dent on India's tax structure by reducing the weight of customs and from the central bank against ad-hoc treasury bills issued by the government. The interest rate on such borrowing was, at around 4.6 per cent, much lower than the interest rate on borrowing from the open market. A crucial aspect of financial reform has been the reduction of such borrowing from the Central Bank to zero, resulting sharp rise in the average interest rate on government borrowing.

With the adoption of economic reforms, reform of public sector enterprises became inevitable. The new strategy essentially involved refocussing but not curtailing state activity and channelising resources and effort in high priority areas. In 1991-92 profit after tax to net worth was 3.9 per cent which rose to 10.2 per cent in 1997-98.[189] This shows an improvement in the rate of return on capital employed in PSUs. Whatever limited progress has been achieved in initiating public sector reforms has largely been linked to the process of disinvestment. The foregoing analysis reveals that the goal has fallen short of expectations and the disinvestment strategy has itself been bogged down by controversies. During 2000-2001 non-tax revenue from dividends and profits from PSUs has exceeded the budget expectations. Thus, the shortfall in disinvestment has been partly offset by this increase. If this pattern continues for a longer period and an enhancement of revenue from disinvestment, it would be very important for retiring of public debt so that the fiscal deficit can be reduced significantly.[194]

There is greater consensus that in the recent past the budgets of the central government were out of balance and now the restoration of fiscal balance is one of the most improtant task in the agenda of further economic reform. There is not only a wide gap between revenue and expenditure resulting in deficits, the composition of expenditure is also quite out of line. Revenue structure needs to be altered to make it more broad based and equitable. Thus, a significant fiscal reform is needed for the restoration of the fiscal stability. 211.

At the conclusion of this tour de horizon of problem of fiscal stabilization in the Indian economy we can say that, though the problem of fiscal stabilization has been sorted out to some extent, but a lot has to be done for consistent and long-term fiscal stability.

6.2 SUGGESTIONS

A few important points may however, be mentioned in the light of above discussion so as to make fiscal stability a long-lasting feature. The key objective of fiscal reform has to be a reduction in debt service payments. This has to be acheived by a progressive reduction in public debt and through higher revenues. The possibility of achieving higher revenues through increased rates of taxes is both undesirable and infeasible. Higher tax revenues can be achieved only through buoyancy and expansion of the tax base. Thus the main instruments for achieving a sustained fiscal balance are :

* The yield of income tax can be increased at least by broadeningthe base and strengthening the administration while at the same time ensuring that the main aim of the administration would be to collect increasing revenues without harassment that the exacting illegal payments will be drastically cut down. The base income tax can be widened by;

a) removing many exemptions that are unjustified and reducing the magnitude of some of the concessions,

b) bringing into the tax net a large number of income earners who are evading tax,

c) introducing such acceptable simplified procedures as the estimated income scheme, and

d) introducing a minimum profits tax on all business income other than income of professionals.

* Effort should be made to bring more companies into the group of tax filers. At the same time, the so-called zero tax companies can be made to pay some tax.

* There is agreement in principle that the base of excise duty must be broadened and the rates must be moderate. Multiplicity of rates is to be done away with.

* The VAT principle should be extended to the textile sector and the tax should be levied at the fabric stage also. For this purpose, the duty on artificial yarn of different kinds should be brought down and some simple way must be found to levy tax on the powerloom sector.

* The base of the services tax should be expanded. In order to minimise possible cascading effect, services which are generally used as major inputs should not be brought under tax and the rate of tax should be relatively low.

* With the rates of custom duties coming down, it would be necessary to subject at most all imports to some import duty. That would also

be economically a rational policy. The minimum rate could be 10 per cent and the maximum rate on goods other than consumer goods should be 30 per cent.

* At first, consumer goods requiring sophisticated technology may be permitted to be imported, then, gradually the imports of other consumer goods should be liberalised. The rate of duty on consumer goods may be kept 50 per cent to start with.

* It is generally agreed that government has overextended itself. Fortunately the economic reform programme has made many activities and the associated staff redundant. Apart from that, gradually the government sector should withdraw itself from the production of private goods.

* The central government should cut down the size of ministries and departments dealing with subjects which are mainly the responsibilities of the states.

* There is an agreement regarding the surplus staff in general administration and also in the administration of functional departments. There is also over-staffing of engineers in the public works department. This surplus staff must be identified and shed off.

* The share of interest payments must be brought down by limiting the fiscal deficit and by retiring some of the existing debt. Given the size of the debt, retirement would achieve only a relatively small reduction in the debt burden. However, through the sale of seized gold and some of the government lands and through disinvestment of PSUs

shares a sizeable amount could be raised and used for the retirement of debt.

* Subsidies have to be reduced mainly because the government cannot afford the luxury of providing wide ranging subsidies for production. Subsidies directly targeted at consumers from the vulnerable groups should be developed and implemented to safeguard the government's objective of income distribution. Carefully developed small projects that are practical and implementable, with a clear beginning and a fixed termination, are more likely to be successful than nationally announced mega projects short of sufficient funds and subject to wide misappropriation.

* Expenditure control mechanisms have to be given teeth. In particular, there should be full follow-up by government departments and resolution of problems after the completion of scrutiny by the CAG's reports.

* A clear position must be articulated to privatise existing public sector enterprises except those that may be regarded as strategic. This action is not only necessary for generating resources for retiring public debt but is also necessary for the long-term health of the enterprises generating themselves. We must adopt a new approach to public sector enterprises which recognises that privatising them would be the best way of making sure that the core of Indian industry grows, remains competitive and is enabled to compete internationally.

* The government must clarify the objectives of the process of privatisation and seek to forge a consensus. The objectives must be

both the strengthening of these enterprises to enable them to compete and grow, and to contribute to the restoration of fiscal health of the country. The return from privatisation must not be used for current expenditures. They should be explicitly used for retiring public debt so that the interest burden is progressively reduced.

* While it is difficult to prescribe a particular size for the public debt, it is possible to set up a monitoring unit with strong recommendatory powers for the containment of public debt. For example, such a writ set up within the RBI and headed by the governor of RBI could be given the final authority to cut off the government's ability to borrow except under specified contingencies. Such extreme measures as earmarked taxes or nonflouting of expenditure ceilings or cut off of the issuance of additional public debt are not warranted under ordinary circumstances. But they are necessary when a country's fiscal performance needs improvement in a hurry.

It may be concluded that viable fiscal stabilization may be restored, if the above suggestions are taken into consideration and implemented in an earnest and proper manner.

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